H.R. 3355, THE HOMEOWNERS DEFENSE ACT OF 2007

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND COMMUNITY OPPORTUNITY

AND THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

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H.R. 3355, THE HOMEOWNERS DEFENSE ACT OF 2007

Thursday, September 6, 2007

U.S. House of Representatives,
Subcommittee on Housing and
Community Opportunity,
and Subcommittee on
Capital Markets, Insurance, and
Government Sponsored Enterprises,
Committee on Financial Services,
Washington, D.C.

The subcommittees met, pursuant to notice, at 2:13 p.m., in room 2128, Rayburn House Office Building, Hon. Maxine Waters [chairwoman of the Subcommittee on Housing and Community Opportunity] presiding.

Present from the Subcommittee on Housing and Community Opportunity: Representatives Waters, Cleaver, Green; Biggert, Capito, and Campbell.

Present from the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises: Representatives Kanjorski, Sherman, Moore of Kansas, Sires, Klein, Mahoney, Wexler, Marshall; Pryce, Capito, Baker, Castle, Putnam, Brown-Waite, Feeney, Campbell, and Roskam.

Ex officio: Representatives Frank and Bachus.

Chairwoman Waters. This joint hearing of the Subcommittee on Housing and Community Opportunity and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order.

Good afternoon, ladies and gentlemen. I want to thank Chairman Kanjorski for joining me to co-chair today's hearing. I would also like to thank the ranking members, Judy Biggert and Deborah Pryce, and each of the members of the Subcommittees on Housing and Community Opportunity, and Capital Markets, Insurance, and Government Sponsored Enterprises, who have joined us for today's hearing on H.R. 3355, the Homeowners Defense Act of 2007.

Without objection, all members' opening statements will be made part of the record.

I look forward to hearing from today's witnesses on H.R. 3355, the Homeowners Defense Act of 2007, introduced by Representatives Ron Klein of Florida, and Tim Mahoney of Florida, both of whom are members of the Capital Markets Subcommittee, and are here with us today.

As you know, the full Financial Services Committee recently passed the Flood Insurance Modernization and Reform Act of 2006,

H.R. 4973, because of the urgency related to the need for flood insurance reform and modernization, particularly in conjunction with the National Flood Insurance Program.

This bill recognizes a similar urgency related to the need to spread risk associated with natural catastrophes. Our most recent experience with Hurricanes Katrina and Rita, where billions of dollars in losses were sustained, put a new twist on natural catastrophes. No one had predicted a storm of the magnitude of Katrina or Rita or anticipated the staggering financial costs of the storms: $40.4 billion in insured losses.

Of course, no one knows what the financial cost of the next catastrophe will be, as catastrophic risk models have been wrong to date. Businesses and homeowners in many States cannot buy insurance. We know when insurance can be purchased, it is unaffordable for most people.

I think it is a plausible idea for catastrophic risk to be shared, pooled, or absorbed by capital markets. As one expert said, "There is a need to spread the risk as widely as possible across the investment world, and in the process, minimize the cost of insuring potential losses from catastrophes."

Natural catastrophe bonds have grown in private capital markets, from a few billion dollars to more than a $14 billion market since Katrina, and the market is expected to continue to grow, as large investors become more actively involved in the market.

H.R. 3355, the Homeowners Defense Act of 2007, provides Federal encouragement or support for States that choose to develop State-sponsored re-insurance programs designed to enhance the efficiency by which catastrophic risks are transferred to the capital markets.

We all know Florida has a State-subsidized pool of $32 billion in catastrophic insurance coverage. While other States have been slow to move in this direction, the question is whether a specific amount is sufficient for the next catastrophe in Florida, California, or elsewhere. If not, how can we encourage risk pools to be created so there is ample coverage for future catastrophes?

This bill will enable the States to have greater latitude to provide insurance for homeowners against catastrophic risk by passing the risk on to our capital markets. Under the bill, States could decide to join the National Catastrophic Risk Insurance Consortium, for the purpose of transferring catastrophic risk to the capital markets through the issuance of risk-linked securities, or reinsurance contracts.

In addition, the bill creates a national homeowners insurance stabilization program with the Treasury, to ensure a stable private insurance market by extended low-interest Federal loans to State-sponsored insurance programs in States that have been impacted by severe natural disasters.

Further, the bill allows for the consortium to develop capabilities related to catastrophic risk analyses, which is active largely in the domain of the private sector.

I am pleased that a debate is centered on this issue, because of the potential for natural catastrophic catastrophes anywhere in this country. As such, I look forward to hearing the witnesses' testimony on H.R. 3355.

I would like to recognize, at this point, Chairman Paul Kanjorski, for his opening statement.

Mr. KANJORSKI. Thank you very much, Ms. Waters. We meet this afternoon to consider and review a bill introduced by our colleagues, Congressmen Klein and Mahoney of Florida.

H.R. 3355 tackles a complex issue: how to address the growing problem of the availability and affordability of homeowners insurance around the country, and especially along our coastlines. I commend my colleagues for taking on such a difficult task. The Financial Services Committee and its predecessors have struggled with this topic for many years.

The costs associated with natural disasters continue to rise. According to the Government Accountability Office, insured losses associated with hurricanes alone have risen from $10 billion in the 1980's to $97 billion for this decade. Some attribute this increase to global warming. Others attribute it to the higher cost of real estate and increased density of high-risk areas. Still others attribute it to climatic cycle where the frequency and intensity of storms is currently on the upswing, that will eventually subside. Whatever the cause, the increase in costs is very real, especially for those who own homes in the areas most affected by natural disasters.

The central question before us today is, therefore: Who should bear these costs? Should it be those who live there, the insurance industry, or the government? The answer could also be some combination of these parties, as well as other sources.

My colleagues have carefully considered these matters in crafting their solution to the problem. In brief, their bill would provide States with an opportunity to plan ahead of time for covering the insured losses resulting from natural disasters via our private markets. Their plan also offers emergency relief in the form of Federal loans for those States that may need access to funds after a major natural disaster.

Specifically, the consortium proposed in Title I of the bill would encourage States to cede risk to the capital markets. I look forward to learning more about the increased role our capital markets can serve in paying for the insured losses of natural disasters. We should, to the extent possible, maximize the risk-bearing capacity of the private sector before calling on the government to assist. Additionally, Title II of the bill creates a Federal loan program that would provide loans to any State facing a significant financial shortfall following a natural disaster if capital is not readily available by any other means.

The bill also aims to avoid the problems that have stalled previous efforts to mitigate the cost of catastrophic disasters for homeowners. States would voluntarily participate in the bill's programs, thereby hopefully avoiding cross-subsidization from States that do not bear similar risks. Additionally, the bill aims to mitigate the transfer of risk to the Federal Government. These important provisions ought to help the legislative prospects for the bill.

In sum, I look forward to hearing from our witnesses today on how H.R. 3355 may affect homeowners, businesses, insurers, reinsurers, investors, and all levels of government. I am also very interested in learning about any recommendations that experts may

have about how to improve and refine the bill, as the committee continues to consider it. Thank you, Madam Chairwoman.

Chairwoman WATERS. Thank you very much. I would like to recognize Ranking Member Biggert for 5 minutes, for an opening statement.

Mrs. BIGGERT. Thank you, Chairwoman Waters and Chairman Kanjorski, for holding today's joint subcommittee hearing on H.R. 3355, the Homeowners Defense Act of 2007.

I commend the authors of this bill, Congressmen Klein and Mahoney, for their very good intentions. They are two members from Florida, a State that has found itself in a difficult position when it comes to insurance. Because their State has failed to produce a workable solution to its insurance needs, my colleagues naturally want to do something to help.

While I applaud their intentions, I'm not convinced that this bill is the best idea for Floridians or for taxpayers from Illinois or other States across the country, who will likely end up paying for it. At this time I question if the legislation we discuss today is the right solution, and would work as successfully as the authors envisioned. Unless evidence convinces me otherwise, I cannot support this bill, and believe that this issue should continue to be addressed at the State level.

And once again, I will say that, like in Illinois, free market pricing should be the model for other States, including Florida. At the same time, I do think that we need to continue to more closely examine the insurance availability and affordability problems that exist in some areas of the country, like we had with the Gulf Coast and with Florida.

However, I am also convinced that even if a majority of our witnesses today testify that H.R. 3355 is a bad idea, my colleagues on the other side of the aisle may, nonetheless, support the legislation. This was the case when the committee took up reform of the National Flood Insurance Program. We held a hearing on a new version of the Flood Insurance Reform and Modernization Act that added wind to the program, and 9 of the 13 witnesses said, "No, don't add wind." But 9 days later, this committee disregarded that advice, and passed a bill that added wind to the NFIP.

With that said, I am very interested in hearing from today's witnesses about the best solution to the insurance dilemma of States like Florida. How have regulatory systems influenced insurance availability and affordability? Why is there availability and affordability in some States, but not others? Are insurers allowed to price for the true risk a particular property faces?

I have to admit that I am biased. In Illinois, free market pricing benefits consumers, ensuring that they will have choices, since insurers are encouraged to compete for their business. I am also interested in discussing ways we might lessen the regulatory burden, boost private market participation, and spur more affordable rates for consumers, without putting taxpayers on the hook.

I look forward to the testimony of today's witnesses as we continue to encourage a more robust market for catastrophic insurance. I yield back.

Chairwoman WATERS. Thank you very much. At this time, I would like to recognize the chairman of the full committee, Chairman Frank, for as much time as he would like.

Mr. FRANK. I thank the chairwoman. I thank members on both sides for letting me do this. I am going to have to leave. We did have a bill on the Floor today, and I have other things I have to get to.

I did want to, first, welcome—I think I may be the only member here who served with Mr. Evans, so we have some continuity here. I was just joining the committee when Mr. Evans was up here on the top row, and it's nice to work again with him. He was always a very important and useful member of the committee.

And I am proud to have a representative from the district of my colleague, Mr. Delahunt, Representative Patrick from my neighboring Cape Cod. I think that's important, because this is not just a Florida issue. We have a representative of Cape Cod here. We have members of this committee from Long Island, who are very concerned about this.

I would hope we would take the approach that a problem doesn't have to exist equally in all States before we address it at the national level. There are varying issues. You know, Illinois doesn't have floods, but Illinois has a lot of agriculture that gets subsidies that we don't get.

I don't think we say that everything has to get on an absolutely equal basis. We are one country, and there will be parts of the country that will face one set of dangers, and parts of the country that will face another set of dangers. And there are parts of the country that have one set of needs, and not others. A lot of programs that we support have only a partial impact.

I also want to address the issue—which the gentlewoman sort of noted with dismay—that we did not follow the consensus of witnesses. I am a great believer in democracy, but polling witnesses at a committee and then using that as a basis for deciding public policy does not seem to be the best way to go. I am always interested in what the witnesses have to say, and the substance.

I noticed—I apologize, I may be mispronouncing Mr. Seo, whose—I read that interesting New York Times article. And he was a great witness, because he closed—he said he asked himself three questions, then answered them. So, if people would follow that rule, we could take the day off. And I don't mind that, maybe, after a busy day. He asked and answered his own questions in a very useful way. It is the substance of what they say—not necessarily the "yes" or "no"—that we want to listen to.

Finally, I just want to say that this is a difficult problem, and I think when people criticize a proposed solution, they ought to be required to take into account the difficulty of the problem. It is very hard to get solutions that are a lot more elegant than the problems they seek to remedy. And the more difficult the problem, the messier the solution will be, the less perfect.

So, I am very much prepared to listen to alternatives. I must say I have been very impressed with the work done by our colleagues, the two gentlemen from Florida, Mr. Klein and Mr. Mahoney. I have been listening and watching and our staffs have participated,

also. They have done as good a job as I have found so far it is possible to do.

Now, it may be that someone could come up with a better proposal than they have. I haven't seen one, but I would say this: I will not be persuaded by people who say, "We don't think the Mahoney-Klein bill is perfect, so let's do nothing." If people tell me that they don't think the Klein-Mahoney approach is as good as approach "X," "Y," or "Z," then, fine, I will look at the other approaches.

But the problem again I want to reiterate is that it is a difficult problem, and the solution cannot totally transcend the problem. It is a national problem. I have heard from people in Massachusetts and people in New York; we have a lot of people living on the coasts.

So, I hope we will go forward. And if people want to suggest some improvements in this proposal, of course we will look at it. That's why we have hearings and mark-ups. But, if the answer is, "This is a very difficult problem, so let's do nothing at all at the Federal level," I don't find that to be an acceptable approach, and I would hope people would feel some obligation not simply to be critical of this, which is relatively easy, because it's a difficult problem that they're addressing, but come up with alternatives.

So for me, at this point I am impressed with the work that Representatives Klein and Mahoney have done, and until somebody comes up with something better—and I haven't seen it—I intend to be supportive. And I have looked at this.

I thank the witnesses for coming. I will give them this consolation. If, in fact, we do not follow the opinion of a majority of the witnesses, I hope they will feel free, in their own lives, to disregard opinions of mine whenever they think that's appropriate. And I thank you, Madam Chairwoman.

Chairwoman WATERS. Thank you very much. Congresswoman Brown-Waite, for 3 minutes.

Ms. BROWN-WAITE. Thank you very much, and I thank you, Madam Chairwoman, along with Mr. Chairman, for holding this hearing today. I also appreciate the witnesses who will be appearing before the committee.

This hearing is long overdue for the residents of the Gulf Coast who have been abandoned in the property insurance crisis they're facing. I have been working to bring relief to these residents for over 3 years, and I thank my colleagues from south Florida, Representatives Klein and Mahoney, for joining me in this fight.

But let me emphasize this very, very clearly: It is not just a Florida problem. I will be listening closely to learn how constituents in various areas of our great country are actually going to benefit from such an approach offered in H.R. 3355.

I also ask unanimous consent that a statement from ProtectingAmerica.org be submitted for the record. Madam Chairwoman? I ask unanimous consent that a statement be submitted for the record.

Chairwoman WATERS. Without objection.

Ms. BROWN-WAITE. Thank you. And, again, I thank you very much for holding this hearing, and I look forward to hearing what our witnesses have to say here today. I think that there are many

valid ways to approach this issue that certainly is nationwide, not just in Florida, and not just on the Gulf Coast. Thank you. I yield back the balance of my time.

Chairwoman WATERS. Thank you very much. Mr. Cleaver?

Mr. CLEAVER. Thank you, Madam Chairwoman. It seems a bit weird for a representative of Missouri—and sitting next to my friend and colleague from Kansas, Dennis Moore, to be here at a meeting dealing with legislation sponsored by two people from Florida. The ocean dried up near Missouri about a million years ago.

But 3 years ago, my wife called our son, who was a student at Dillard University in New Orleans, and said, "Look, we've heard that there is a hurricane warning for New Orleans, and you need to go." But my son said the basketball coach wanted them to stay. He was on the team—and I must also unnecessarily say the captain of the team—and so the coach said, "We're going to stay. We get these warnings all the time."

The threat came and left. And so, on August 24, 2005, when tropical depression number 12 began to hit the news, I didn't think much about it, because I had bought into what happens in New Orleans, which is that you ignore it. I had no idea that tropical depression number 12 would eventually destroy $70 billion of insured property.

And because I saw what happened then, I am starting to pay a little more attention to history. On December 16, 1811, an 8.0 magnitude earthquake hit New Madrid, Missouri. It was so powerful that bells began to ring in downtown Boston, Massachusetts.

And so, I am in the middle of the country, but nonetheless concerned about what the Federal Government is going to do in a similar catastrophe. And I am concerned about the fact that we do need, I think, a backstop that would help provide coverage for individuals, even in the middle of the country. I yield back the balance of my time.

Chairwoman WATERS. Thank you very much. Mr. Castle?

Mr. CASTLE. Thank you very much, Chairwoman Waters, Chairman Kanjorski, and Ranking Member Biggert. This is a very interesting hearing. We have not dried up in Delaware. We have 25 miles of oceanfront, and a lot of bay and riverfront along the Delaware River, so we are very concerned about this.

But I wanted to take my time, if I may, to introduce somebody who probably doesn't need introduction to a lot of people in the room, and that is former United States Congressman Tom Evans of Delaware, who is here to testify today. He currently serves as—and this is shortened from a much longer bio—he currently serves as the chairman of the Florida Coalition for Preservation. The Florida Coalition for Preservation is a not-for-profit organization that promotes responsible growth and protection of barrier islands along our coast.

Congressman Evans was a member of the former House Banking Committee, which is now our committee, the Financial Services Committee; the Merchant Marine and Fisheries Committee; chairman-elect of the Environmental and Energy Study Conference; and vice chairman and chairman-elect to the Arts Caucus. He also serves as a delegate to the UN Law of the Sea Conference.

He was well known for putting coalitions of Democrats and Republicans together, and as a result, he was able to achieve major legislative victories. For example, he was the author of the Coastal Barrier Resources Act that curtailed Federal land development funding in environmentally sensitive barrier islands. His legislation has saved the American taxpayers billions of dollars.

He served as the Republican Floor leader for the Alaska Lands Act, he was the Republican leader for U.S. funding for multi-lateral development institutions, and was co-chairman of a coalition encouraging enactment of the Caribbean basin initiative, and other trade measures.

He also served as leader of a congressional coalition to eliminate funding for pork barrel projects, in order to reduce the deficit, and was co-author of the first successful bill to ban dumping of sewage sludge in the Atlantic.

Mr. Evans has served on numerous corporate, educational, and charitable boards, and has received national awards from the Nature Conservancy, the Sierra Club, and Americans for the Coast, and Alaska Wilderness League for his leadership in preserving millions of acres of wilderness.

I thank both of the Chairs for holding this important hearing today. I look forward to hearing from the experts, such as Tom Evans, on the impacts of this legislation. I think it's a very significant hearing. I yield back the balance of my time.

Chairwoman WATERS. Thank you very much. Mr. Scott?

[No response]

Chairwoman WATERS. Mr. Scott is gone. Who is next?

Mr. GREEN. I believe I am, Madam Chairwoman.

Chairwoman WATERS. Mr. Green.

Mr. GREEN. Thank you.

Chairwoman WATERS. Thank you.

Mr. GREEN. Thank you, Madam Chairwoman. And I also thank Chairman Kanjorski for the two of you working together to host this hearing, as well as the ranking members.

I am honored to have this august panel today to give us some insight and I look forward to hearing what they have to say. But my belief is that we have a de facto policy in place, currently. The de facto policy is that in a national crisis, the Federal Government does step in.

9/11 was a national catastrophe, and we did step in, and we did the right thing. Katrina was a national disaster. We stepped in, and we spent more than $100 billion. I happen to think that we have done the right thing, notwithstanding the fact that some of the money has not been used as judiciously, in my opinion, as it should have been. But I think that the government, right now, is in a de facto position of, when we have a national crisis, of being a hand in a time of a national crisis.

So, I think that my colleagues from Florida—both of whom I commend highly—have merely codified a sensible methodology by which we can plan a response, as opposed to doing it on a case-by-case basis, and having a de facto policy. They have thoughtfully and prudently given us at least one means by which we can involve private enterprise before the event, before the occurrence of the event, and also allow government to play a role.

I really don't know that we can do it much better than they have codified it. But I, too, look for a better strategy, a better methodology. And if it is available, I would gladly review it and would embrace it, if it's better. But in the interim, given that we do have—and we do know that we will have—additional circumstances that are unpleasant to deal with, I thank them for having the vision to give us a means by which we can at least embrace a process beforehand. I yield back the balance of my time.

Chairwoman WATERS. Mr. Feeney.

Mr. FEENEY. Well, thank you. One thing we know in Florida is that hurricanes are not a partisan issue, and I want to thank Congressman Klein and Congressman Mahoney for coming forward with a proposal. And Representative Brown-Waite—and I know this because before our freshman colleagues joined us, we have had bipartisan proposals in the Congress, I think Congressman Wexler knows that, as well.

And I am mindful of, I think, the chairman of the full committee's chastisement that criticizing people who come forward with answers to complex questions is, in some ways, inherently unfair. But the corollary to that is that just because you have a complex solution to a complex problem, it doesn't mean the solution will improve things.

And so, I think it's fair, with a very difficult problem to deal with that Floridians know a lot about, that we struggle in a bipartisan way to get a solution that will improve things.

And I am mindful that the consortium that this bill contemplates is not mandatory. It doesn't necessarily require that anybody participate. States that want to participate in the risk of one disaster or another are permitted. But that would be permitted under current laws the Treasury testimony provides.

What this bill does do is to suppose that if there is a consortium that is started, that there is an implied guarantee of subsidized loan rates in the event of certain events. I think Mr. Evans points out in his testimony one problem with that is that it may incentive risky behavior. I think the Treasury Secretary also talks about the FAIR system that encourages people to remain in vulnerable areas which are attacked by natural disasters over and over again, and that seems to violate one of the principles that good insurance policy would want to contemplate.

Florida has developed a very enhanced building code. I know that Congressman Klein and Congresswoman Brown-Waite and I were there at the time, and we required homeowners to do those things. This bill doesn't require that.

This bill doesn't make any—it doesn't provide any insistence to insurance companies that enhance reserve requirements, as Congresswoman Brown-Waite's bill would do. Representative Wasserman Schultz and I have a bill that would encourage individuals to put aside money for very high deductibles, which we have in Florida that other States may not have experienced.

And so, I think this is a fascinating proposal that needs a lot of discussion, and it is a complex solution to a complex problem, which doesn't necessarily mean it's going to make things better. And so, this member will stay tuned, and continue to participate. With that, I will yield back.

Chairwoman WATERS. Thank you very much. Ranking Member Pryce just came into the room. I would like to recognize her for 5 minutes.

Ms. PRYCE. Why, thank you. I appreciate that very much. But in the interest of time, until we get to the meat of things, I will waive my opportunity and look forward to the testimony. Thank you, Madam Chairwoman.

Chairwoman WATERS. Thank you very much. The next member to be recognized is one of the authors of this legislation. I know how hard he has been working, and I know how anxious he is to share with us his deep feelings about what he has embarked upon. And it gives me great pleasure, and I am very proud, to ask one of our newer members to please give us 5 minutes' presentation on his bill.

Mr. KLEIN. Thank you very much, Madam Chairwoman. And I would first like to thank Chairman Frank for his guidance and support. And, of course, Chairwoman Waters and Chairman Kanjorski and the Republican leads on both subcommittees, for holding this hearing today to discuss H.R. 3355, the Homeowners Defense Act of 2007.

This is a bill that Congressman Mahoney and I have been working very hard on, and I want to pay special tribute to the expertise that Congressman Mahoney has, and that he brings to the Congress in the financial services area, because it has been extremely valuable in thinking through this issue over the last several months.

It has been suggested by the prior parties that were introducing their comments that this is a complex issue, and it is. We know that we want to address the concerns of displaced homeowners, protect the financial solvency of States, and to stimulate the insurance markets.

It is also important to understand that insurance availability and affordability problems have become a national issue. Congresswoman Brown-Waite has already stated this, as well as Congressman Feeney, and I think we all understand that.

Hundreds of thousands of homeowners across the country have already had their insurance coverage dropped, or are currently slated for non-renewal by their insurance company. Those who remain, in many cases, are confronted with crippling premiums, which, in some cases, is forcing homeowners to make tough decisions about whether to go without property insurance or not—which, of course, those people who have mortgages, and most people do, don't have that alternative.

Insurance problems are not limited to Mississippi, Louisiana, or Florida. Last year, property insurers indicated that they planned to stop offering new coverage in parts of Maryland and Virginia's coastal markets. They have also stopped in certain areas of Delaware, New Jersey, and Connecticut, no matter where the property is located within the State, not just on the coast.

Furthermore, tens of thousands of homeowners in Massachusetts, New York, North Carolina, South Carolina, Alabama, and Texas have already been dropped, as well. Added to that is, even with California's known record of seismic activity, over 85 percent

of California homeowners currently do not have earthquake insurance. That's a pretty substantial number for us to consider.

It is unacceptable for property owners not to be able to get reliable coverage in their markets. And it's precisely this reason that we have moved to come up with some solutions. Our legislation aims to take a two-fold approach, by establishing a program to help States responsibly manage their risk before disaster strikes, while also providing financial assistance to ensure that they can quickly and efficiently respond to homeowners' insurance claims following a natural catastrophe.

Specifically, the bill provides a venue for State-sponsored insurance funds to voluntarily pool their catastrophe risk with one another, and then transfer that risk to the private markets through the use of catastrophe bonds and reinsurance contracts.

The legislation also allows for the Federal Government to extend low-interest loans to cash-strapped State insurance funds after a large-scale natural disaster, so that they can meet their obligations to homeowners.

By utilizing these new strategies, and an innovative, flexible capital market approach, this bill allows investors to assume some of the risk currently held by the States in return for an interest payment or a premium payment.

The voluntary nature of this program, coupled with the use of the capital markets, ensures that homeowners in less disaster-prone States will not be on the hook if a disaster strikes a neighboring State. I want to emphasize that the opt-in nature of this plan creates no obligations or burdens whatsoever on States that do not wish to participate; this is a very significant new way to approach this.

The total economic impact accompanying natural disasters resonates throughout the entire Nation. Total economic damages from the 2005 hurricanes will likely exceed $200 billion, with the Federal Government responsible for paying out an excess of $109 billion, and probably a lot more, for disaster relief.

Although we all agree that it's necessary, as was suggested already, this Federal spending has drawn equally from taxpayers in every State of our country, not simply from those of the affected regions. Through this legislation, we are looking to take a proactive approach where States responsibly plan in advance of a disaster rather than a reactive approach where the Federal Government opens the Treasury after a catastrophe.

I want to note that, although we have a bill in front of us, we will continue to work with all of you who have an interest in this, who are stakeholders, who may want to find ways to improve the text, as was already suggested by our members and our Chair. In striving to produce the most effective bill possible, we welcome any suggestions that would help us fulfill our underlying goals, utilizing the framework that we have established.

But I would like to make one thing clear that I think we all feel very strongly about; the status quo is no longer an option. We have to work together, in a bipartisan way, with the industry and with our consumers to establish a system where property insurance is both available and affordable for hard-working families and those

most in need. We feel this is a good piece of legislation in that direction, and I thank the chairwoman for the time.

Chairwoman WATERS. Thank you very much. Ms. Capito?

Mrs. CAPITO. Thank you, Madam Chairwoman. In the interest of time, I will waive my opening statement, and listen intently to the hearing. Thank you.

Chairwoman WATERS. Thank you very much. The other author of this bill, a gentleman who had a hearing earlier today on a great piece of legislation for seniors, and who has put a lot of time, also, on this bill, and I know how important it is to him, Mr. Mahoney?

Mr. MAHONEY. Thank you, Chairwoman Waters. It has been great spending the day with you, working on these many issues.

And it's always tough going after my colleague, Congressman Ron Klein, and I want to thank him for his great leadership, and all the years that he has spent in the Florida legislature, dealing with this issue. His experience and knowledge of this matter has been tremendous, in terms of coming up with this legislation. I would also like to thank Chairman Kanjorski, for his leadership, as well as Chairman Frank.

Before we begin summarizing the natural catastrophe insurance crisis affecting Florida, I want to reiterate that this is a national problem. And let me be clear, the Federal Government has been forced to act, because private markets for homeowners insurance have failed.

The issue, ladies and gentlemen, is not industry's ability to pay claims, it is an American's ability to purchase affordable homeowner's insurance. This legislation is essential, as the investment in a home is the single biggest investment an average American citizen has, and it is vital that we protect the American dream of homeownership.

I am proud that this bill preserves the private homeowners insurance industry. It recognizes that no one got into business to underwrite a nuclear devastation which—made by man, or made naturally. This bill is voluntary, so States can choose to participate or not.

However, it sets a principle that no longer will the American taxpayer foot the bill for a natural disaster with an expensive bail-out. We know that these catastrophic events will happen, and this bill ensures that we plan for them in a manner that is cost-effective and recognizes personal responsibility.

In 2004 and 2005, natural disasters resulted in approximately $89 billion in privately insured catastrophic losses. These disasters and population growth in areas prone to natural disasters have caused the insurance industry to adjust their models for insuring these events. As a result, insurers and reinsurers are pulling out, or reducing their exposure in disaster-prone areas of the country. Today, in my home State of Florida, the citizens of my State are the owners of the biggest homeowners insurance company, with over 30 percent of the market.

In addition to lost insurance capacity, homeowners have seen their premiums skyrocket. The toxic cocktail of rising gas prices, healthcare costs, and homeowners' insurance has created a vicious cycle of terror for our seniors living on fixed incomes, and middle-class families struggling to provide for their children.

Recently I received a letter from one of my constituents detailing the difficult choices she had to make in order to pay her homeowners' insurance bill. Ms. Leanne Finnigan, a single mother of two from Stuart, Florida, was dropped by her insurance company in 2006.

She eventually found another insurance company which charged her more than 3 times what she had been paying for similar coverage. As a result, she has been forced to work overtime on Saturdays, and to give away one of her family pets and reduce her weekly grocery budget. Unfortunately, Ms. Finnigan's story is not unique. Thousands of families across Florida have been forced to make similar difficult decisions.

The Financial Services Committee has held numerous hearings on this same issue. During these hearings, several facts became clear: the risk posed by natural catastrophes is not going away; the damage caused by disasters will keep growing; and the insurance premiums have remained high, despite the 2006 storm season being relatively calm.

The Homeowners Defense Act of 2007, which Congressman Klein and I introduced, is a two-prong approach, designed to address the property insurance crisis, ensuring a stable insurance market that will give States impacted by severe natural catastrophes the ability to help their citizens rebuild their homes and their lives.

Title II of the National Homeowners Stabilization Program extends low-interest Federal loans to States impacted by several natural disasters. These loans, which will be paid back by the States, will allow a State catastrophe fund to cover its liability in the event that it is not fully funded at the time of the disaster, and assist in covering damages that exceed its liability.

Because the legislation utilizes private capital markets and a loan program that requires repayment by affected States, it eliminates cross-subsidization. Taxpayers in Nebraska no longer have to bear the risk of those living in Florida. This legislation is responsible, fair, and returns stability and competition to the private insurance market.

I look forward to working with the members of this committee and key stakeholders, to ensure that this legislation adequately accomplishes its intended goals. And again, I would like to thank Chairman Frank, Chairwoman Waters, and Chairman Kanjorski for holding this hearing today, and I look forward to hearing the comments of our witnesses. Thank you very much.

Chairwoman WATERS. Thank you very much, Mr.—

Mr. MAHONEY. Oh, one other thing. I would like to ask unanimous consent to add Ms. Finnigan's letter to the record.

Chairwoman WATERS. Without objection, it is so ordered.

Mr. MAHONEY. Thank you very much, Madam Chairwoman.

Chairwoman WATERS. Mr. Roskam?

Mr. ROSKAM. Thank you, Madam Chairwoman. In the interest of time, I waive my statement, and I look forward to the witnesses' testimony.

Chairwoman WATERS. Thank you very much. Mr. Wexler.

Mr. WEXLER. Thank you, Madam Chairwoman. I will be brief. I just want—as an original co-sponsor of Mr. Klein and Mr. Mahoney's bill—to point out a few things that I think are quite rel-

evant. Mr. Klein and Mr. Mahoney and I held a hearing this past week in West Palm Beach, and heard from, I think, a wide array of business community leaders, industry leaders, regarding this issue last week.

And what I think deserves repetition is that Mr. Klein and Mr. Mahoney, even though they are new to this body, have done an extraordinary thing in, one, persuading the leadership that homeowners insurance is a proper venue for Federal action. And we are extremely grateful to Speaker Pelosi, to Chairman Frank, to Chairwoman Waters, and the others, for enabling Mr. Klein and Mr. Mahoney to put forth the legislation that they have.

This is a private sector solution. And this is a meeting of extraordinary, and at the same time, competing demands, but doing it in a rational and responsible way. I will close by simply following, I think, an argument that Mr. Feeney, our friend from Florida, makes, which is a very deserving point, and that is that States like Florida have already adopted many meaningful reforms, both in terms of requiring building codes and individual action, as well as significant insurance reforms.

But even though the State of Florida, led by a Republican Governor and a Republican legislature—and, I believe, acted in earnest, and did their very best—and I think Mr. Feeney would agree—they took their best shot at resolving the homeowners' insurance crisis in Florida. It didn't stop the bleeding. Still, tens of thousands of homeowners in Florida continued to lose their policies.

So, for all the people who argue for State action, for all the people who argue for individual responsibility, for all the people who argue that the Federal Government may not have a role, well, Florida has done exactly what you said. We have implemented it, and we still have a huge problem.

So, I would respectfully suggest that Florida is actually the best example of why Federal action on homeowners insurance is not only advisable, but it is absolutely necessary, because even when a State legislature acts responsibly, as the Florida Governor and the Florida legislature has done, it is still not enough.

And why isn't it enough? Because even a large State like Florida, with all of the resources that it brings to this problem, cannot affect the private market in a way big enough, like the Federal Government can. And that's what Mr. Klein and Mr. Mahoney's bill designs to do, bolster the private sector, so that it is financially responsible for investors to again participate in the homeowners insurance market. And that's what we attempt to do. Thank you, Madam Chairwoman.

Chairwoman WATERS. Thank you very much. I would now like to introduce our first panel of witnesses, including: the Hon. Phillip Swagel, Assistant Secretary for Economic Policy, U.S. Department of the Treasury; the Hon. J.P. Schmidt, insurance commissioner, State of Hawaii, on behalf of the National Association of Insurance Commissioners; the Hon. Matthew Patrick, State Representative, Masssachusetts House of Representatives; and the Hon. Tom Evans, chairman, Florida Coalition for Preservation.

I would like to thank all of you for appearing before the subcommittee today, and, without objection, your written statements

will be made a part of the record. You will now be recognized for a 5-minute summary of your testimony.

Mr. Swagel?

STATEMENT OF THE HONORABLE PHILLIP SWAGEL, ASSISTANT SECRETARY FOR ECONOMIC POLICY, OFFICE OF PUBLIC AFFAIRS, UNITED STATES DEPARTMENT OF THE TREASURY

Mr. SWAGEL. Chairwoman Waters, Ranking Member Biggert, Ranking Member Pryce, and members of the subcommittees, thank you for inviting me to testify again to the committee.

The Administration opposes H.R. 3355, the Homeowners Defense Act of 2007, because its provisions are at odds with the goal of ensuring that there is a stable and well-developed private market for natural hazard insurance and reinsurance.

Recent increases in insurance rates in coastal areas have been difficult for many homeowners. This, however, is fundamentally a reflection of the risk involved, not a defect of the market. Instances of reduced availability of private insurance likewise present a challenge. Generally, these can be traced to State regulatory actions.

H.R. 3355 would create a federally-chartered natural catastrophe risk consortium to issue risk-linked securities and enter into reinsurance contracts. But State-sponsored programs are already free to pool risks and they have access to competitive reinsurance in capital markets, designed to pool risks, globally.

Reinsurance contracts and financial instruments entered into by a consortium with a Federal charter would be seen as carrying an implicit Federal Government guarantee. This would mean subsidized coverage for the participating States, but a hidden cost to all taxpayers that puts the Federal Government at risk for future liabilities.

H.R. 3355 would also establish the National Homeowners Insurance Stabilization Program, through which the Treasury would provide loans to State insurance programs at below-market rates before and after catastrophes. This would reduce the need for States to purchase private reinsurance and charge adequate rates to maintain capital reserves—again, at a cost to the Federal Government and to all taxpayers.

The subsidies provided by the consortium and the stabilization program would encourage State-sponsored programs to offer subsidized insurance and reinsurance. This would result in the displacement of private coverage, lead to costly inefficiencies, and retard innovation in the private sector.

Lower insurance premiums would reduce incentives to mitigate risks and make taxpayers nationwide subsidize insurance rates in high-risk areas. The Federal Government would face potentially large liabilities since it might be expected to step in to support the operations of the consortium and face pressure to forgo full repayment of stabilization program loans.

Allowing private insurance and capital markets to fulfill their roles is the best way to maintain the economic sustainability of communities at risk of natural catastrophes. Federal Government interference would crowd out an active and effective private market for natural catastrophe insurance, increase the incentive for people

to locate in high-risk areas, result in potentially large Federal liabilities, and be unfair to taxpayers. For these reasons, the Administration opposes H.R. 3355.

[The prepared statement of Assistant Secretary Swagel can be found on page 164 of the appendix.]

Chairwoman WATERS. Thank you very much.

Next, we will hear from the Honorable J.P. Schmidt.

STATEMENT OF THE HONORABLE J.P. SCHMIDT, INSURANCE COMMISSIONER, STATE OF HAWAII, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. SCHMIDT. Chairwoman Waters and Chairman Kanjorski, Ranking Members Biggert and Pryce, and members of the subcommittees, I thank you for the opportunity to testify here today on H.R. 3355, the Homeowners Defense Act of 2007, and I thank you for addressing this very important issue. My name is J.P. Schmidt, I am the insurance commissioner for the State of Hawaii, and I am here today on behalf of the National Association of Insurance Commissioners.

Last month, in the span of just 24 hours, my State was hit with a magnitude 5.4 earthquake while we watched Hurricane Flossie, at the time a category four storm, head towards our islands. In addition, at the same time, an earthquake in Peru generated a tsunami warning. A lava flow from Kilauea Volcano began winding its way toward old Hilo Town, and we were midway through a week-long brush fire, burning thousands of acres on the Waianae Coast.

Fortunately, the recent earthquake and the weakening hurricane were relative modest, in terms of insured losses. The tsunami didn't develop, and the fire was kept from buildings and residences. However, we are still keeping an eye on the lava flow. But it is safe to say that Hawaii knows something about living with and managing the threat of natural disasters.

Representatives Klein and Mahoney have put forward a bill intended to help States and insurers better manage the threat of natural catastrophes. We commend them for their leadership and for recognizing the important role States play in managing the threat of natural disasters.

In those areas where private market property coverage is either unavailable or unaffordable, States have stepped in to fill the gap with wind pools, insurance incentives, reinsurance funds, and, in the case of Hawaii, a hurricane relief fund that provides coverage after the occurrence of an event.

The NAIC has adopted guiding principles for evaluating Federal catastrophe insurance proposals, and has used them to consider H.R. 3355. The full evaluation is included in our written statement. Generally speaking, we are encouraged that the Homeowners Defense Act meets many NAIC guiding principles. However, the proposal's viability will ultimately depend on how it is implemented, and on the willingness of States, insurers, and investors, to all participate.

The NAIC sees the risk consortium as a possible mechanism to help lower potential losses to State catastrophe funds by extending them to the capital markets. The capital and surplus of the residential and commercial property insurance market is approaching

$500 billion, while the global securities is over $50 trillion. The financial impact of a $50 billion storm would be relatively small, then, if absorbed in the securities marketplace. This risk transfer mechanism for States would create another avenue to cede risk, similar to the role of the reinsurance marketplace.

Another beneficial aspect of the consortium is the process of cataloging the various risks of its participants. With better information about underlying risks, market participants would have greater confidence in projected outcomes, and a better sense of a fair price. Although securitization is an important tool to spread risk, it is not a panacea. We see it as a vehicle that augments, but does not replace, the traditional reinsurance market.

A key unknown that will determine the impact of this type of approach is the appetite of the investment community, and the impact of consortium products on the attractiveness of those securities already on the market.

The loans created by Title II of the bill help spread the timing risks associated with large natural disasters. The loans leverage the capacity of the Federal Government to allow State funds, for those States that choose them, to better manage risk and help reduce volatility in the market, by giving insurers less exposure to truly catastrophic events. This approach allows States to tailor their programs to allow the private insurance and reinsurance markets to be the first line of defense, but recognize the inevitability of government obligation for catastrophic events.

The loan approach will work best in an area when all the insurance entities in that area can take advantage of it. For that reason, a reinsurance type facility would be a better structure for managing the flow-through for loans than a residual market wind pool. A wind pool, as a direct writer of insurance, does not have the ability to provide a backstop to insurers in a region.

For all consumers to benefit, States would either need to create a separate reinsurance entity, or restructure their residual market entity to take on this additional role. Although we cannot anticipate which State will choose to take advantage of this program, the Federal backstop aspect seems to provide an incentive for States with an affordability problem to consider this approach.

The insurance and reinsurance markets have a significant amount of capacity, and access to that capacity for events that are small yet frequent is generally affordable. But for those who live in areas where events can be infrequent yet catastrophic, access to insurance capacity is either unavailable or unaffordable. This is the dilemma that regulators and legislators must face together.

Again, we commend Representatives Klein and Mahoney for their leadership on this important issue, and we thank the subcommittee for the opportunity to testify.

[The prepared statement of Mr. Schmidt can be found on page 141 of the appendix.]

Chairwoman WATERS. Thank you very much.

The Hon. Matthew Patrick, State of Massachusetts.

STATEMENT OF THE HONORABLE MATTHEW C. PATRICK, STATE REPRESENTATIVE, THE COMMONWEALTH OF MASSACHUSETTS

Mr. PATRICK. Thank you, Madam Chairwoman. I am Representative Matt Patrick, from the third barnstable district in Massachusetts. The third barnstable district is on Cape Cod, that arm that sticks off of Massachusetts into the Atlantic Ocean. I am accompanied by my colleague, Sarah Peake, from the fourth barnstable district, who is on the financial services committee in the legislature in Massachusetts.

I am here to speak in favor of H.R. 3355. We have a problem in the Commonwealth of Massachusetts, as was stated before. We can help ourselves, with a little help from the Federal Government, and I think H.R. 3355 will do just that.

Back in 2003, our constituents started complaining. I feel like we are your colleagues that are closer to the people, in that regard. When I go to the supermarket, I hear from people exactly what's bothering them, and homeowners's insurance is the biggest problem on their minds since 2003.

Insurance companies have left—or have increased rates from $700 in 2003 to roughly about $1,700, on average. The Mass FAIR plan, which is the insurer of last resort, has gone from 3 percent of the market to 44 percent of the market on Cape Cod, Martha's Vineyard, and Nantucket Islands. They have also increased rates 25 percent, with approval from the insurance commissioner, and have applied for another 25 percent increase. The free market is not working.

And I want to also reinforce the fact that you may not realize this, but not all of us are rich on the Cape and the islands. Sixty-three percent of the workers who are employed on the Cape and the islands work in retail trade or the service sectors. The average wage is $20,000, according to the 2000 census. That may have increased slightly, but it's still not up to what the Crittenton Women's Union estimates that a family of four needs to live without any frills, which is about $58,000.

Twenty-five percent of our residents on the Cape and the islands are senior citizens on fixed incomes. Many of them have canceled their homeowners insurance. They don't have mortgages, so they can do that, but it puts them at an incredible risk, because they're at risk of fire, or anything else. But they simply can't afford the increases. All of this is driven by reinsurance, computer models—private computer models—and global warming.

The FAIR plan expenses for reinsurance—just to give you an example—have increased dramatically. In 2005, the FAIR plan spent $17.5 million for $500 million worth of reinsurance. In 2006, they spent $43 million for $455 million in reinsurance. And this year, 2007, the FAIR plan spent $75 million for $979 million in reinsurance. That's all money that could be going into our own reinsurance pool, to build it up.

Right now, we are having trouble getting the legislation passed. We have a senate bill, 624, which would maintain the private insurance companies, give them the backstop with our reinsurance pool, and also help us establish our fund in 7 to 10 years.

But we need that 7 to 10 years to establish our own fund. And with H.R. 3355, we will be able to give our colleagues the reassurance that we will be able to—we will have the backstop, we will have some guarantee that we won't have to increase the assessment on all insurance policies across the State, if we do have a catastrophic event before the fund is built out. So, it would be politically helpful to us to have H.R. 3355 to get our bill passed to create a catastrophic insurance fund in the Commonwealth of Massachusetts.

We would also like to see this tax-exempt status—and I know that's beyond your purview—but we would like to see that clarified, so it's a definite. But, again, we think it's a good bill. It definitely would help us.

And thank you for this time to testify. I appreciate it.

[The prepared statement of Mr. Patrick can be found on page 138 of the appendix.]

Chairwoman WATERS. Thank you very much.

Next, the Hon. Tom Evans, chairman of the Florida Coalition for Preservation.

STATEMENT OF THE HONORABLE THOMAS B. EVANS, JR., CHAIRMAN, FLORIDA COALITION FOR PRESERVATION

Mr. EVANS. Madam Chairwoman, thank you. Thank you very much for inviting me, and a special thanks to Congressman Castle for his kind words. It was good to see my friend, Barney Frank, the chairman of this committee now, who served here when I was sitting on the top row, and he was down here.

I think the approach Chairman Frank outlined earlier is a very good one, because I think we should look at all the alternatives. We should advance the process carefully forward. And I am glad to be here with three gentlemen who represent an area where I spend a lot of time; I teach at Florida Atlantic University, and chair the Florida Coalition for Preservation.

The older I get, the more I am concerned about the future, particularly for my grandchildren and other grandchildren like them all over this country. And one of the things that concerns me the most is the amount of money we spend, because it affects everything that we do. It affects our national security, and it affects people's lives tremendously. We need to spend tax dollars as efficiently and effectively as possible.

I remember voting for an increase in the debt ceiling to $1 trillion in 1980. And now, in the last 6 years, we have increased the debt ceiling by another $1.5 trillion, just in 6 years. That is unacceptable. It took us 200 years to get to $1 trillion. I think we should be doing something about that, and that brings us to today's hearing on H.R. 3355.

On the surface, especially if you're from Florida, Congressman Klein and Congressman Mahoney's bill sounds good. However, in my view, I don't think there should be a rush to judgement to mark up this bill before considering it, before looking carefully at all aspects, and before looking at other opportunities you have, gentlemen, as far as this bill is concerned. I think there is an appropriate role for government and the private sector and each should be examined.

But I would like to bring your attention to several concerns I have about H.R. 3355, because of its complexity. One is to be careful; don't displace agents and brokers, and don't replace the private sector's involvement in insuring and reinsuring. And don't mask the risk involved.

Let me share with you a recent experience that I have had over the last 4 to 5 months. It involves south Florida, and it involves a development, a little town by the name of Briny Breezes. You may have heard about Briny Breezes. Some developers offered $510 million for Briny Breezes, about 40 acres of land. Briny is an old trailer park.

Now, that's about $13 million to $14 million per acre. And, ladies and gentleman, the only way you could make that economically feasible is to go up, way, way up, with high rises. And in this instance, they suggested on this 40-acre plot 1,200 condominium units, with high rises ranging from about 12 to 14 stories to 20 to 22 stories, a 349-room luxury hotel, and a greatly expanded yacht marina, with retail shops, restaurants, etc.

Briny was and is a classic example of a barrier island in south Florida situated between the inter coastal and the Atlantic Ocean. And what we tried to do with our coalition was to point out, to educate the people, to make sure that policymakers at every level understood the complexities involved. We wanted them to understood that this type of intense irresponsible development would greatly and dangerously stress the surrounding infrastructure: transportation; water supply; the emergency response time for vehicles of all kinds; evacuation problems, etc.

Our Coalition appeared before the State of Florida to make our case in Tallahassee. Tom Pelham was the secretary of community affairs. He has the final responsibility in determining whether or not a comprehensive plan is or is not acceptable. And they determined that it was not acceptable. Now, that was a reasonable decision, but nothing compelled the State to find the comprehensive plan presented by the developers unacceptable.

Most of the standards used in Florida's Growth Management Act are subjective, they are not objective. They are not codified in law. And the more you reduce the risk, it seems, ladies and gentlemen, the greater opportunity you have to access capital markets, and the greater opportunity for reduced premiums. It just makes good common sense.

The national catastrophe fund envisioned by the legislation you're considering today does not address the responsibility of States to reduce risks and mitigate losses that will occur in the event of a catastrophic storm.

An ounce of prevention—and I will finish in one minute, if I may, Madam Chairwoman—an ounce of prevention is still worth a pound of cure. And I hope you will include in this legislation that you're considering today—and will be considering, hopefully, for weeks ahead—a requirement that States demonstrate that they are taking initiatives that will reduce risks and mitigate damages to the maximum degree possible: tough building codes, for example, and very importantly, some standards that prevent intense development on vulnerable, storm-prone barrier islands.

The Florida legislature could pass amendments to the Growth Management Act that would take care of that. And you all could suggest that they do so. This would be tangible recognition that the States understand that, in accepting assistance, any form of assistance, they must bear their fair share of responsibility. We should encourage this type of action. And we should discourage unreasonable risk-taking.

I hope you all consider that, and I thank you very much for having me here today.

[The prepared statement of Mr. Evans can be found on page 95 of the appendix.]

Chairwoman WATERS. Well, thank you very much. I would like to recognize myself for 5 minutes for questions. My first question is directed to you, Mr. Swagel.

Katrina/Rita hurricanes were devastating, and they have caused a lot of pain to many, many people, not only the people who were impacted or affected by it, but for those of us who have tried to forge solutions to the tremendous problems that have been created.

This problem of the denial of claims by the private insurers is particularly painful, where the denials are such that some homeowners are in a state of shock, thought they were covered both for wind and for flood, only to have the insurance companies fight them, tooth and nail, to keep from recognizing or honoring their claims.

We also saw a lot of threats from private insurers to pull out. They said, "We're leaving," not only in the Gulf region, but also there were those threats in Florida. And for those who have stayed, the rates have increased tremendously in some areas, particularly in the New Orleans area. I was just there, and went over this.

So, given the problems that we have experienced, the number of uninsured—and Mr. Klein is absolutely correct— I'm from California, and most of us don't have any earthquake insurance.

Given all of these problems, do you still—am I to understand that your testimony is such that you said the Administration opposes any Federal role in the natural catastrophe insurance market, and that Federal Government interference in a functioning natural hazard insurance market could crowd out an effective, private market? I mean, is that what you're saying?

Mr. SWAGEL. Yes, Madam Chairwoman. The Administration opposes the provisions of the bill, as written.

Chairwoman WATERS. But I would like to know a little bit more—

Mr. SWAGEL. Sure.

Chairwoman WATERS. —about your opposition to any and all Federal role in any natural catastrophe insurance market. Is that a true statement?

Mr. SWAGEL. No. You know, I was just thinking of what Chairman Frank had said. And I thought that was a fair way of putting it, you know, his challenge. You know, "If you say no"—and obviously, my testimony says no—"what do you support?" So there are things that the Administration supports. I could go through them, if that—

Chairwoman WATERS. Does the Administration recognize the problems that Americans are faced with in these flood-prone areas? Well, and all of the perils that we experience in this country.

Mr. SWAGEL. Absolutely.

Chairwoman WATERS. And, if so, do you have another solution?

Mr. SWAGEL. Absolutely, you know, the role of insurance in rebuilding is critical, and we see that in the Gulf States and in New Orleans, as you pointed out. And the disagreement, of course, is what is the best way to foster the insurance market, and make sure that people have the ability and access to insurance.

Chairwoman WATERS. We have two different approaches that have been presented by members who are trying very hard to offer their constituents and our citizens some measure of protection. Do you have something that we do not know about?

Mr. SWAGEL. I want to say a few words that—I think this is responsive about the Administration's approach, and what we support, and what the Administration is doing.

Starting at the Federal level, with—in the Department of Homeland Security, efforts to support mitigation, substantial funding in the President's budget, Federal assistance to help State and local governments improve their mitigation efforts, to improve the quality of the flood maps, for example.

At Treasury—you know, obviously, we're a bit removed from that—the role of Treasury—and this is something Secretary Paulson has spent a lot of time on—is on the competitiveness of our capital markets, which, of course, sounds quite removed from floods and catastrophes. But, of course, that's what this is all about, is making sure that we can tap into active capital markets, to foster that reinsurance.

Chairwoman WATERS. Well, we all, I think, support—on both sides of the aisle—mitigation. And, as was represented here today, we should insist on reducing risk, wherever we can do that. But meanwhile, it's going to take some time to get the maps redone for these flood zones. It's going to take time to get mitigation to the point where it can be helpful.

So, I was just wondering, do you have any other answers? Do you have any other proposals that you could present to Congress that, perhaps, would be helpful?

Mr. SWAGEL. The staff of Treasury have worked with the staff of the committee in discussing some of the provisions of this bill to help us understand them, and we're happy to continue to work with the staff.

Chairwoman WATERS. So you have not closed the book on this legislation? You're still reviewing it? And there is some possibility that you could support some parts of it? All of it? You may have some suggestions, but you will work with these authors, is that right?

Mr. SWAGEL. We are happy to continue talking to the committee.

Chairwoman WATERS. I am sorry, I didn't hear you.

Mr. SWAGEL. We are happy, yes, to continue talking to the committee.

Chairwoman WATERS. So, am I to take that to mean that you will be happy with work with these authors, to try and make this bill even better, so that you could possibly support it?

Mr. SWAGEL. As written, the Administration—

Chairwoman WATERS. I know, "as written," but what we're looking for—we're looking for an open door for some interaction and exchange and cooperation to solve the very desperate problems of the victims of these disasters. Are you willing to work with them?

Mr. SWAGEL. Yes. Treasury staff, we were out talking to the committee yesterday, exactly to understand the provisions of the bill. And we are happy to continue—

Chairwoman WATERS. All right. Thank you very much. Ranking Member Biggert?

Mrs. BIGGERT. Thank you, Madam Chairwoman. Just for the record, I would like to clarify that Illinois is subject to flooding. And, as a matter of fact, we had a major flood in August. It was suggested that maybe we don't have all the mountains and all the things, or the coastal, but we did have a major flood in which—it could have been worse, except for the mitigation, I think, that was in Illinois. But in northern Illinois it was bad.

I would like to ask, first of all, Mr. Swagel, how could the risk-based pricing, FAIR risk-based pricing, like we do have in Illinois, help to temper the growth in Florida? Wouldn't this help with the availability problem, since insurers would find a risk-based regulatory regime a more inviting environment in which to do business?

Mr. SWAGEL. Yes, that's right. And as we look at the markets, one of the things that we see is that the places in which States have tended to interfere with the workings of the insurance market, there has been the unintended consequence of reducing the availability.

Mrs. BIGGERT. Okay. Then, Mr. Evans, you talked a lot about mitigation, and mitigation at the local level and the Federal level under the National Flood Insurance Program has been crucial to reducing damage from flooding and storms, particularly where there is a repeating event. So I don't think that H.R. 3355—it doesn't specifically describe mitigation, does it?

Mr. EVANS. As I read it, it doesn't, Congresswoman Biggert. But it should. You could add that, and that's why I suggest that you don't rush this through to a mark-up on September the 18th or earlier. You should not consider such a complex bill after only one hearing.

Mrs. BIGGERT. Thank you. And then, Commissioner Schmidt, I understand that the Hawaii State catastrophic fund created after a hurricane in 1994 was eventually dismantled as unnecessary. Do you know what factors led to the State to conclude that that fund was no longer needed?

Mr. SCHMIDT. That's not quite correct, Representative Biggert. It was not dismantled. It was wound down, however, and we still have a considerable amount of money available to reactivate the hurricane relief fund, in the event of a hurricane.

The way it is designed is it's intended to go into action once a hurricane hits, and it's assumed that the insurers, at that point, will tend to pull out of the market, and not want to participate, as they determine the losses that they are suffering. At that point, our citizens still need their insurance coverage. The hurricane relief fund provides insurance coverage for everyone. And those insurers that remain in the market are exempted from the assessments for

the operation. Then, as the market settles down, the hurricane relief fund is wound down, as insurers come back into the market, and we have a more settled market for our citizens.

Mrs. BIGGERT. I don't quite understand what you mean by "wound down." Don't you still have to fund, or do you build up the fund in the event that there is another catastrophe?

Mr. SCHMIDT. In the event that there is another catastrophe, we would have to build the fund up. We have a certain amount that we are retaining, that will help us get the funds started.

But then, the fund will be increased through the premiums collected from the individuals, from assessments of insurance companies, and then, as I said, provides the primary coverage, purchases reinsurance, and ensures that our citizens do have coverage, so that they won't default on their mortgages, and so that we can get back on our feet quicker.

Mrs. BIGGERT. Do you have any idea how many States currently have reinsurance funds that would qualify for Title II loans?

Mr. SCHMIDT. I do not know the exact number off the top of my head. But certainly that is something that we can get for you.

Mrs. BIGGERT. I would appreciate that. Do you think that this bill would incentive more States to form such a fund?

Mr. SCHMIDT. Yes, I think it would. I think, because it provides a—you know, one good approach to dealing with a very difficult situation, a catastrophe, it provides support and a backstop for the private sector, the private insurance industry, in its coverage of our citizens.

Mrs. BIGGERT. Okay, thank you. My time is up. I yield back.

Chairwoman WATERS. Thank you very much. Ms. Pryce?

Ms. PRYCE. Thank you very much. I want to extend my appreciation to our panel for your patience, and for your informative testimony, and I thank the chairwoman for holding this hearing today. I think it's important that we tackle this issue.

At the same time, I think we need to do so in a way that really looks at it carefully, so that it protects not only policyholders but also taxpayers, and the solvency of the insurance industry, in general. I am just a little bit skeptical—but very open minded—about any Federal bill that includes little in the way of risk reduction and mitigation. I think we can improve upon this product by looking at that very carefully—but also, a bill that encourages direct government involvement at such low levels of loss, and has no guarantee that the actual savings will be passed on to the taxpayer.

And so, as you answer my questions—and any of you witnesses—please feel free to address any of those things that are troubling me.

Specifically, let me ask about the consortium aspect of this bill. The purpose of that is—part of the purpose of this bill—is to establish this consortium for interested States that would be used to buy reinsurance for them, or to issue catastrophic bonds.

Can any of you tell us how that would work, and whether you think that this is really a new Federal law that is actually necessary, or is this already possible among States? Is it already happening in the reinsurance market? Is it already—don't we already—haven't we already seen some hedge fund involvement? And

would you compare this to a new government sponsored enterprise, if we do go this route?

That is a lot of questions in one. Mr. Patrick, you have your hand up. Go right ahead.

Mr. PATRICK. Thank you, Congresswoman. I just want to remind you that this is in the form of loans. I mean, you would get a lower interest rate for loans, so the States still do bear quite a bit of responsibility. They are not going to make it easy, in my mind, for people to build on the coast, for example, or to build 20 stories in the air. I think those things will be regulated on a State level.

But, from my own perspective, it has been difficult for us to get our bill, our Massachusetts catastrophic fund bill passed but with assurance from the Federal Government that they will back us up in the 7 to 10 years that it takes to establish—I mean, to make our fund self-funding, I think we can get it passed.

I cited some numbers to you about our FAIR plan. They are donating—or, they are not donating, but they are paying tens of millions of dollars for reinsurance every year. And that is gone. If we don't have a catastrophic event, that is gone. That money could be going into our fund to build it up.

Ms. PRYCE. Tom? You indicated you had something to say about this.

Mr. EVANS. Well, you expressed some concerns that I have, as well. Is it a new government enterprise? The gentleman who authored the bill suggests that the Secretary of the Treasury is going to be the chair of the committee. Two other members of the Cabinet are involved in that committee. It seems to me that is fairly close to a government enterprise.

And the other question is, do the States have the opportunity to do precisely what this legislation suggests that they should do? I don't have the answer to that, but I think that needs to be addressed. You need to focus on that and it cannot be accomplished in one hearing.

Ms. PRYCE. Thank you. Assistant Secretary Swagel, Federal catastrophic reinsurance bills have been introduced many times over the years, and this bill looks a lot like them, except it uses the term "loans," rather than "reinsurance."

Do you have an opinion as to whether a real solvency loan bill—wouldn't it kick in at a higher rate of loss than this, when there is a clearer threat to the industry, or the market, rather than a way to basically smooth the premium changes from year to year? It seems like that's what would be accomplished by this, as opposed to assurances for the market, in general.

Mr. SWAGEL. Right. We share the concern that you said at first. This kicks in very quickly.

I share some of the concerns you also stated just before that, you know, we look at the consortium and don't understand what is there that can't be done now, and end up in the same place. There is an implicit government guarantee there.

And you kind of look forward and say the fundamental problem is the rate suppression, and what does that mean about the ability of the people taking out the loans against the Treasury to eventually repay those loans? And that's—you know, that's the fundamental problem, as we see it.

Ms. PRYCE. All right. Thank you, Madam Chairwoman. My time has expired.

Chairwoman WATERS. Thank you very much. Mr. Sherman?

Mr. SHERMAN. Thank you. I want to thank the Chairs for holding his hearing, and the authors for authoring this bill. Our committee has already passed terrorism reinsurance; this is critical, not only to provide coverage for victims, but also to make sure that buildings get built, and buildings get sold.

We recognized, with terrorism, that we needed a good insurance system, and the private sector couldn't do it all by itself, because the losses were hard to predict, and involved tens of billions of dollars. It seems like the natural disaster situation is identical, and even cries out more for Federal involvement, because the harm is not just that things won't get built or get sold.

We had a little crisis in my area—I represent Northridge—where you couldn't buy or sell a home for a few months, or at least it was very difficult. We need an insurance system that works. These things are hard to predict. They involve tens of billions of dollars of cost, and a backstop of a similar nature seems to be called for.

Mr. Swagel, you are here, in part, to defend the Treasury of the United States. We pass this bill, you have a contingent liability to put on our national balance sheet. But at least it would be scored, acknowledged, admitted to by Treasury.

Right now, we have a different system, and that is we have absolutely no liability any time we have a natural disaster. But every time it's big, we pass a supplemental appropriation. Right now, shouldn't the Federal balance sheet have a little footnote on it saying, "We have no legal liability, except the legal liability to spend the money that Congress forces us to spend, or appropriates," and we would estimate over the next century, that we're talking between $100 billion and $1 trillion in supplementals that will be passed over the next 100 years.

And does the Federal balance sheet have that footnote, and shouldn't it?

Mr. SWAGEL. You know, I agree with what you said about the approach now, that after a catastrophe, as a nation, we look at what's happening, and then the Congress decides what to do.

The problem with the approach in the bill that's written is one of both fairness and incentives. The incentives in the bill, for people to, unfortunately, put them in harm's way—and it's something we've seen for the flood insurance—and then, for the States, it's what I said before to the ranking member, that it's for the States to essentially suppress the rates, knowing that the Federal Government is back there as a backstop.

Mr. SHERMAN. I would just point out that if we do absolutely nothing—you have insurance. You don't have insurance if you're flooded by a small flood, because then it won't be on the front page of the newspapers right here in Washington.

But the fact is, all those things exist now. You know that if your community is hit by a big flood, there is going to be a supplemental, and it's going to benefit those people who have—are uninsured. If you incentivize people to buy insurance, then at least they are contributing something.

You would have to be a very cold-hearted legislator—and perhaps Mr. Evans can identify—and you may very well become a former legislator, if you're going to turn a blind eye to people suffering from a natural disaster, and instead, send them a letter about how they should have bought insurance and/or mitigated their risk.

Mr. Evans, I know a lot of attention is focused on building in a floodplain. There are more floods than there are earthquakes. Coming from California, I would say, "Thank God," not that we would—but we would want to have, of course, fewer of each.

But I would hope that you could work with this committee, not only to talk about where people build, and how we mitigate risk—because often the way to mitigate risk from a flood is to not build in the floodplain—but also focus on earthquakes, which I realize is the problem less talked about, in terms of building standards, because, as I mentioned earlier, the Federal Government is going to get left holding the bag, one way or the other, with or without this bill.

And if we want to minimize Federal costs, we're going to have to push States and push individuals, in one way or another, to build the right way in earthquake zones, like my entire State, and to build in the right place and in the right way in flood zones. Does your organization—I mean, you talk about how—it looks like my time is expiring. I will ask whether your organization has specific proposals as to how to mitigate losses, how this bill can be improved.

Mr. EVANS. Let me just answer that, Congressman Sherman—it's good to see you again.

Mr. SHERMAN. It is good to see you, too.

Mr. EVANS. I would be happy to work with these gentlemen. They live pretty close to me, down there in south Florida, and I would be happy to work with them on addressing the reason we need to reduce the risks. I think that is a duty that we have, and I think it is a duty that the States have, as well. The States should share in the responsibility.

I agree, that we need to respond to people who are in need, and respond to people who don't have insurance in a national catastrophe, whether it's an earthquake, a flood in the Midwest, or wherever it is. Or, a hurricane in hurricane alley. We're right in the middle of it. These gentlemen live right in the middle of it. But I think we also have a parallel duty and responsibility to do what we can to reduce the risks.

Mr. SHERMAN. Thank you.

Chairwoman WATERS. Mr. Castle?

Mr. CASTLE. Thank you very much, Madam Chairwoman. And let me, Mr. Swagel, ask you a question. I may ask Mr. Evans, as well.

H.R. 3355 contains little in the way of mitigation directives to States that either join the consortium or apply for a loan. There is a provision in that bill that states, "The funds receiving these loans must comply with building codes designated by the Treasury Secretary," which I thought was a little bit unusual. I don't know that Treasury Secretaries are necessarily familiar with building codes.

Do you think that is the appropriate agency to set such codes, or has the ability to designate to do that, or do you think this is outside of the scope of Treasury's expertise?

Mr. SWAGEL. No, there is no expertise for this at Treasury. It is certainly outside our scope.

Mr. CASTLE. All right. So it's probably something we should be looking at, if we go forward with the legislation? All right.

And that sort of ties in, Congressman Evans, with what you were talking about earlier. I assume that you would agree with that answer?

Mr. EVANS. Absolutely I would, Congressman.

Mr. CASTLE. Let me go a little further with you. I am very concerned about some of the—you raised the issue, I don't remember the name of it, but of a small 40-acre space of landing, and building—

Mr. EVANS. It is called Briny Breezes.

Mr. CASTLE. —right, and building a great high-rise—I won't remember now, either—and raising a high-rise there, and the possible overcrowding that comes with that. And, let's face it, we see that all along the coastal areas. We see it in Delaware, we see it throughout. And this concerns me.

In other words, you're putting a lot of dollars into that kind of housing, and they are charging a lot for it, and there is a lot of pressure on the local zoning people to do this. But if there is a tragedy of some sort in the form of a hurricane or wind damage, or whatever it may be, there are huge cost implications that I don't think are necessarily taken into consideration.

And whether it's the plan that we have here, or State agencies, or insurance companies, it seems to me that we are—

Mr. EVANS. You are absolutely right.

Mr. CASTLE. We are dealing with something that is a little bit out of hand.

Mr. EVANS. You are absolutely correct.

Mr. CASTLE. I would like your comments on that.

Mr. EVANS. You are right, Congressman Castle. What happened with Briny Breezes is, at the local level, they wanted to do everything they could to get $1 million per trailer lot. You know, most of us may have accepted that. But, as I told them—we want to work with you to bring about responsible development there, and responsible development in other parts of Florida. The proposal they accepted is irresponsible.

But—and people say to me, "Oh, Tom, you can't take away their right to sell their property." I said, "Yes, but freedom stops at the end of the other fellow's nose." And if you're destroying a community in the process, then you have to stop. But you're absolutely right. What we need to do is do something at the State and national level that will take care of this. Because, generally speaking, at the local level they approve permitting, just as we do in Sussex County, for example, in southern Delaware.

In Delaware, virtually anyone who comes up with a plan at all will get a permit to build just about anything they want. And that's why we need something at the national level that I think does address this problem of mitigation, and reducing risk, and reducing—minimizing the losses.

Mr. CASTLE. I assume when you say something at the national level, you're talking about some sort of general guidelines, and you're not asking—

Mr. EVANS. General guidelines—

Mr. CASTLE. —the national government to get involved with—

Mr. EVANS. For example, the Coastal Barrier Resources Act that I authored here a number of years ago had tremendous bipartisan support. We don't see a whole lot of bipartisan support anymore, but I think this is an example of where you could have some Members of Congress working together for a change.

What I would like to do is to expand the concept of the Coastal Barrier Resources Act. What we said was, in these storm-prone, vulnerable barrier islands, if you are going to develop, do it on your own nickel and not the American taxpayers. Now, we can't prevent people from building in storm-prone areas, but we can eliminate subsidies, including flood insurance. I think we could apply that principle to redevelopment on barrier islands.

For example, if you had a whole bunch of houses, or three-story condominiums in the same spot, rather than tearing those down and building 20-, 25-, or 30-story condos and hotels that dangerously stress the infrastructure, it would seem to me that you could have a new bill, or an extension of the principles in the Coastal Barrier Resources Act that would discourage such redevelopment.

Mr. MAHONEY. Will the gentleman yield?

Mr. CASTLE. Let me just make one statement, and I will be happy to yield. I don't know if I'm going to run out of—well, my time is going to be up. I can't even make my statement. I yield back, Madam Chairwoman.

Chairwoman WATERS. Thank you very much. Mr. Cleaver?

Mr. CLEAVER. Thank you, Madam Chairwoman. I would have loved to have had the opportunity to work with you, Mr. Evans. I appreciate your comments, particularly along the lines of—about bipartisan work. I think we're going to have to get back to—Congress is going to dip far lower than it is now.

I am hoping my comments don't come across as facetious to Mr. Swagel, but I am—because I am trying to understand something. The insurance industry, shortly after tropical depression number 12, known as Katrina, devastated the Gulf Coast region, ended up having some of the largest profits ever. And I am—and it troubles me that with probably $60 billion, $70 billion in insured—damage to insured properties, that the insurance industry could have the highest levels of profitability ever. And at the same time, insurance rates have increased exponentially.

Help me. Because I think most Americans are not going to buy that. Most Americans are going to try to get a headache, trying to understand that. Can you "un-headache" me?

Mr. SWAGEL. Thank you. I will try. You know, as you know, of course, the insurance industry is regulated mainly at the State level. So, in terms of profits, I would really have to look at the State level.

I certainly agree with what you said about—and others have said this, as well—that after catastrophes in the past, insurers have withdrawn from markets. And what has been interesting over time

is that phenomenon has become less so, and the re-entry has been quicker.

And there is a sense in what you say, that the record profits, and the sort of level of profitability is an indication of that, that capital does come back into the insurance markets quickly. And some of this reflects the role of financial innovation. And, obviously, in the second panel, you're going to hear from some of the people involved in this innovation.

You know, I'm sorry, I didn't talk about rates, but I will stop there.

Mr. CLEAVER. Well, I was just going to say that the headache is still pounding.

Mr. SWAGEL. Should I—

Mr. CLEAVER. Can you say it differently? Maybe it will stop me from hurting. I mean, I—do you—this is—I wish we were just two of us in a room—do you actually think most Americans would hear that and say, "Oh, well now, I feel better."

Mr. SWAGEL. The hard thing is that the rates are going up, and there is no denying that, and it is very hard for families—

Mr. CLEAVER. Which is what most people are concerned about.

Mr. SWAGEL. And that's what you start with. And that's where you start—I think it's exactly right. And the hard thing is to say—you have to look at the rates and say, "Why are they going up?"

And as anyone who read the New York Times magazine story—I guess it is 2 weeks ago, now—

Mr. CLEAVER. Yes, I read it.

Mr. SWAGEL. Yes, so the—you know, there is a—there has been a change in the prevalence of catastrophes, and a change in the modeling of them, and people's beliefs about both the impact of the catastrophes, and the financial consequences.

And that's what I meant in my statement, that the rates, while a challenge, are a reflection of the risk. They're not a defect of the market, it's just part of the market mechanism.

Mr. CLEAVER. Madam Chairwoman, I will suppress my desire to continue this, in the interest of making sure my colleagues have more time to be involved, dialogically, with this issue. I yield back the balance of my time.

Chairwoman WATERS. Thank you very much. Ms. Brown-Waite?

Ms. BROWN-WAITE. Thank you very much. Madam Chairwoman, I want to assure you that the Administration is bipartisan in their opposition to anything that is going to help the homeowner. They opposed my bill, and I had mitigation in my bill. So I want you to know that. They are absolutely bipartisan in their opposition.

Mr. Assistant Secretary, let me get this straight. I am also from Florida—I'm originally a New Yorker, so I tend to be real blunt here, okay, I'm not a sweet southern belle, nobody has ever accused me of being that.

[Laughter]

Ms. BROWN-WAITE. I didn't need all that laughter. So, certainly mitigation is missing from this bill. Your comment that, you know, we need mitigation and an updating of flood maps—sir, do you know what an updating of flood maps already does to the already stressed homeowner out there?

Gee, they are already paying very high insurance bills. And then, because we update the flood maps, which I agree is probably, you know, an important thing to do, then they are also faced with flood insurance. This is not what the homeowner needs to hear, sir, when we have a slow-down in the housing market, and you have, not just Florida, but other States having problems with insurance. The insurance commissioner from South Carolina sat here last year and said her rates were going up 300 percent. So it is not just a problem in Florida.

You know, in your testimony, you said something like State-sponsored programs encourage people to locate in high-risk areas. Do you consider the State of Florida to be a high-risk area? Could you answer that?

Mr. SWAGEL. Well, the State of Florida is at a higher risk of hurricanes than some of the other inland States, yes.

Ms. BROWN-WAITE. Well, obviously so, because we're a peninsula. But, you know, without Florida's CAT fund, or insurer of last resort, nobody in this State could get insurance, not just those living on the coast. My district goes just about to the center of the State. Those people couldn't get insurance, either.

And the Administration's, you know, "let them eat cake" attitude does not help any Member on either side of this aisle. We need to work together to come up with some solutions here, not just well, let's redo the flood maps; or, let's do mitigation. Because you know what, sir? There are already 18 million people living in the State of Florida. My district has grown by over 200,000 people in the 5 years since I have been representing it, so that is not an answer.

And so, you opposed my bill when it has mitigation in it. What is your solution? Not in gobbledygook, okay? In plain English, 50 words or less. Help me out, here.

And also, I would like you to address one other issue, and that is that, under this bill, there is no limit on the number of loans that a State can take out, nor is there a limit on the amount, nor even any requirement that there be a certification that the loan can be paid back. Is that situation just setting up a virtual trough for States to go to that might act as a disincentive to them, having what might be called smart insurance reforms? I would like to hear your comments on that.

Mr. SWAGEL. On the first point, you know, I look at last Friday, with the President's announcement about the Administration's approach to helping homeowners, very targeted help, helping people stay in their homes. That's the Administration's approach, trying to—as plainly as possible, as directly, not in a confusing way, help the people most at risk.

Ms. BROWN-WAITE. Sir, with all due respect, that relates to the mortgage problem.

Mr. SWAGEL. Absolutely, absolutely. You asked me what the Administration's approach is that—the Administration would never do anything to help homeowners. I'm sorry, that's what I was answering first.

Ms. BROWN-WAITE. So, for Floridians, and those on the coastal areas certainly, that phenomenon was going on, but they also have the unaffordability issue. So, what would you support?

Mr. SWAGEL. Right. The situation in Florida, in some sense, has two challenges, and they are related. There is the unaffordability challenge, and there is the lack of availability. These are related. The State actions to address the affordability challenge has led, unintentionally, to an availability challenge.

Ms. BROWN-WAITE. Madam Chairwoman, may I have 30 seconds?

Chairwoman WATERS. You can, and I would be happy to extend that, but I am getting very concerned about whether or not your heart can take it.

[Laughter]

Ms. BROWN-WAITE. I'm from New York, I'm tough.

Chairwoman WATERS. All right. Without objection.

Ms. BROWN-WAITE. Let me break that down. Is what you're saying that people aren't paying enough for insurance? If that's what you're saying, I want you to come down to any place on the Gulf Coast, especially Florida, whether it is the two gentlemen on the other side of the aisle, or my district, or somebody from the Panhandle, and I would like to see you get out of that room alive if you tell those people they are not paying enough for insurance.

Chairwoman WATERS. You don't want to try to respond to that, do you?

[Laughter]

Mr. SWAGEL. No, I was thinking about that, and then I think you helped me out.

Chairwoman WATERS. He is all yours, Mr. Green.

Mr. GREEN. Thank you, Madam Chairwoman. Mr. Swagel, are you familiar with a highly technical term, "fish or cut bait?" I would beg that you fish or cut bait.

Let me ask you simply if we incorporate mitigation as you have embraced it, and update the flood maps, would you then support the bill?

Mr. SWAGEL. No, sir. The Administration—

Mr. GREEN. You would not.

Mr. SWAGEL. —opposes the bill.

Mr. GREEN. Right. Let me ask you this. Is there anything that we can do, such that you would support the bill? Anything?

Mr. Evans has given us a road map. He has said, "If you will do these things, then I will give consideration to it," and I greatly appreciate your comments, by the way.

So, I ask you, Mr. Swagel, sir, is there anything that we can do that would cause you to say, "The Administration will support the bill?"

Mr. SWAGEL. You know—

Mr. GREEN. Mr. Swagel, permit me to say this. Sometimes when people finish, I don't know whether they have said yes or no. So I will ask you to kindly say yes or no. That would help me, immensely.

Mr. SWAGEL. It—

Mr. GREEN. Yes or no?

Mr. SWAGEL. There is no yes or no answer. You know, it's like I said before, we have talked—the staff at Treasury has talked to the committee staff, and are glad to keep going. The Administration—

Mr. GREEN. I will take it that your answer is no. Let me go to another area. You are familiar with wind damage versus water damage, and how this became an issue in the Gulf Coast, especially in Louisiana and Mississippi.

Mr. SWAGEL. Yes, I am.

Mr. GREEN. But, for edification purposes, we had insurance companies—not all, but some—that would collect premiums, and when the damage occurred, would contend that it was water damage, as opposed to wind damage, which, if they could prevail with this premise, would mean that they would not have to pay for the damage. Did I state that fairly accurately?

Mr. SWAGEL. That was the issue discussed at the hearing before, yes—

Mr. GREEN. All right. Given this proposition, the insurance companies under your de facto program will continue to collect premiums, and they then—not all, but some will do it, and if one does it, it's too many. And then, when the time comes for them to fish or cut bait, they will make the argument that it's the Federal Government's responsibility, notwithstanding premiums collected: "It's the Federal Government's responsibility, because it was flood damage."

And in some of these circumstances, we would have houses right near each other, wherein one company concluded that it was wind damage, and the other concluded that it was flood damage.

So, the company keeps the premiums, the Federal Government does what governments ought to do in times of catastrophes, and it steps in, and it helps its citizens. That's what we will continue to do, if we continue with the de facto policy that you have embraced.

Now, it just seems to me that there is something wrong with that picture. It just seems to me that if we can find a way to, beforehand, before the event occurs, make reasonable steps to have a program such that people can spend some of their money, such that the marketplace can participate, and that the government does have some role, it just seems reasonable.

Because, right now, the insurance companies will place you in long-term litigation. For edification purposes, that can be 3 to 5 years. And while you're in long-term litigation, your home is not being repaired. You are living, literally, in trailers. Have you been to the Gulf Coast, by the way?

Mr. SWAGEL. No, not—

Mr. GREEN. Have you been to New Orleans?

Mr. SWAGEL. I have been to New Orleans, but not since the—

Mr. GREEN. I would invite you, if you could, to please visit and see what people are actually experiencing. If you get a chance, sir, and you can see what it's like to lose everything and not know what the future holds for you.

Finally, I will tell you this. There are many people, Madam Chairwoman and Sir, who are still at a point where they cry when they talk about this. They literally break down and cry. The government hasn't been there, as they see it. The private market wasn't there for them. And these were people of means. We're not talking about people who were in poverty. And they have not been able to recover, to this day.

So, this is but a means by which we can use good will to try to mitigate and to try to be of help. I just hope that you would see it that way, and take a visit down to the Gulf Coast. I believe that it could be of benefit to you. I thank you for coming in and testifying today, and I yield back the balance of my time.

Chairwoman WATERS. Thank you very much. Mr. Roskam?

Mr. ROSKAM. Thank you, Madam Chairwoman. First of all, I want to commend my freshman colleagues for stepping up to the plate with a substantive bill that is not renaming a post office, and it's really real, and you're doing your best here.

I come representing an adjacent district to Mrs. Biggert, and I am actually, very interested in this, because I feel like I'm kind of representing the people who are invited to dinner and we're going to have a fabulous meal, and at the end of the dinner, maybe Mrs. Biggert and I are going to be there with our taxpayers going to be paying the tab.

So, I think the great challenge going forward—and I've always looked at the challenge here—is the people who are proposing change are those people who have the burden of moving forward. It is not people who come with a little bit of a skeptical eye that have the burden of figuring it all out, it's the proponents of bills who have the burden of answering all the questions, and satisfying the critics.

So, my wife and I recently bought a dog, much to my dismay. I thought we were going to get through all four children without owning a dog, but we were worn down. And when we finally got the dog, friends who are also dog owners said a very simple thing. They said to me, "Look. You get what you pet. When the dog jumps up on you, don't say to the dog, 'You bad dog,' and kind of ruffle its ears. You get what you pet."

So, I'm thinking to myself as I'm listening to this, we're going to get what we pet. We're going to get—as taxpayers, we're going to reward the type of behavior that we subsidize. And the great challenge, I think, moving forward, is how do you create the environment where you're not rewarding inherently illogical behavior?

It is not logical to expect Illinois taxpayers, or other taxpayers, to subsidize a lifestyle living on a glorious Gulf Coast somewhere—which is great living, if you can get it—but please don't ask the taxpayers of the Illinois sixth district to subsidize that choice.

Now, I realize that I am overly simplifying that. I realize that there are some subtleties to that. But it was instructive for me, the way Mr. Evans characterized this, in that the local folks on the ground in that development that he described a couple of minutes ago were very eager for the development. Great idea, you know, "We're going to open up this, we're going to get property tax revenue from this, we're going to enhance our community from this."

But there is a logical disconnect between that purchase decision, that decision to develop that property, and the ultimate liability that is sometimes hidden in this whole thing, and that is what rolls in, in a catastrophe.

So, I come with an open mind. I come with a district that recognizes we have a national responsibility here, and that we're all Americans, and we're all in this together. But let's not characterize this as a private sector solution. It's not a private sector solution,

it's an invitation for the Federal Government to play a very big role in this whole thing.

And I understand the desire, when States fail, and are unable to come up with solutions to try and go to Washington. I mean, that's great. If I were representing an area, I would try to be a proponent of that, too. So I am not criticizing anybody for advocating for their district.

But what I am saying is that I think we need to change the tone of the conversation somewhat, and that there may be opportunities for us to work together, but let's call it what it is. This is a massive federalization. But I think we really need to creep and crawl and walk. Thank you.

Chairwoman WATERS. Thank you. Mr. Mahoney?

Mr. MAHONEY. Thank you very much. Mr. Swagel, you say the Administration believes that the private insurance markets for insurance are active and effective, is that correct?

Mr. SWAGEL. Yes, sir.

Mr. MAHONEY. Are you saying that, in the opinion of the Administration, that the citizens of the State of Florida owning the biggest private insurance company, 30 percent of the market, are you saying that the Administration considers that to be active and effective?

Mr. SWAGEL. No, this is a case where—

Mr. MAHONEY. Thank you. Does the Administration believe that every—well, let me ask you this. Does the Administration believe that it is—should be a goal of every American citizen to be able to try to buy their own home?

Mr. SWAGEL. Yes.

Mr. MAHONEY. Okay. Let me ask you something. What do you see as the cost of $1 billion worth of reinsurance? Could you give me an answer for that, please?

Mr. SWAGEL. Well, it depends on the purpose of the reinsurance.

Mr. MAHONEY. For homeowners insurance. Let's say a 1 in 10-year event, what's the cost of $1 billion worth of homeowners reinsurance on a 1 in 10-year event? Do you know?

Mr. SWAGEL. No, I don't know—

Mr. MAHONEY. Do you know what it is on 1 in 100 years?

Mr. SWAGEL. No, I do not.

Mr. MAHONEY. Okay. If I told you it was anywhere from $550 million to $100 million per billion, do you think that that's reasonable?

Mr. SWAGEL. You know, again, it reflects the underlying risks.

Mr. MAHONEY. So you do think that that's reasonable?

Mr. SWAGEL. You know, I don't have enough information to—

Mr. MAHONEY. Is that—so you don't know?

Mr. SWAGEL. Yes, there is not enough information to answer—

Mr. MAHONEY. Okay. Do you know what the State of Florida would have to pay—you know, they have a State catastrophe fund that's being paid for. And, in fact, this bill doesn't ask people to not walk away from personal responsibility. This says every State has the option. And, should they have the option, they would have a State catastrophe fund that would be actuarially sound, so that every State would have to take the responsibility for where their citizens lived. Did you understand that in the bill?

Mr. SWAGEL. That's in the bill, yes.

Mr. MAHONEY. Yes. Then my question is that in the State of Florida, where we have had a $28 billion fund that has been whittled down to $6.8 billion, do you know that it was—$650 million would have been the cost from Goldman Sachs to get a commitment letter to raise the other money to fill out the fund? Did you know that?

Mr. SWAGEL. I didn't know that specific—

Mr. MAHONEY. Do you think $650 million for a piece of paper from an investment bank saying they will raise the money, is that a reasonable amount of money to pay?

Mr. SWAGEL. You know, I don't have the information to evaluate that.

Mr. MAHONEY. Well, I would suggest that I was very disappointed, because it wasn't 15 seconds after we dropped the bill that we had a statement from the Administration saying that they were not going to support the bill. And I am very disappointed that we are having testimony from somebody here today who really isn't prepared to discuss this seriously.

Because when you take a look at what is going on here in the State and the country—and it's not just Florida, sir, it's all across the country—the issue here is affordability and availability.

So, with that, I will go on to Mr.—Congressman Evans. I would like to first point out to Congressman Evans, if you were to come back to Congress today, we would be happy to welcome you as a Blue Dog Democrat, as you are somebody who is obviously concerned about runaway debt and fiscal responsibility.

But I would like to point out very quickly that in Title III, section 301(a)4 of the bill, it does talk about mitigation. And in that bill, it does—in the bill, what it says is that the Department of Treasury will have the responsibility, prior to extending any loan, to make sure that they are satisfied that there are reasonable programs in place to mitigate, and to make sure that we're not reinforcing unreasonable behavior.

So, my question is—really quick, because I'm running out of time—what are the things that we could do in this—the Department of Treasury could do—that could enhance mitigation? Because I agree with you. We can't reinforce bad behavior. And this bill doesn't reinforce bad behavior. Matter of fact, it makes mitigation a requirement in order to be able to get a loan from the Federal Government.

Mr. EVANS. I would like to see you a little more specific about what the mitigation would be, and I would be happy to work with you on that, Congressman.

Mr. MAHONEY. Okay. As far as my colleague, Mr. Roskam, who has left, he is a dear friend of mine. And he makes a good point. You have to be careful what you pet.

And coming originally from the State of Illinois, born in Aurora, Illinois, what I would like to point out is that, you know, we have an illogical situation right now. What we are petting is a situation where people do not have insurance coverage to protect for catastrophic funding.

It is every American's belief, in the case of a natural disaster, that the Federal Government will come in and will give a bail-out.

And a bail-out is a situation where every taxpayer in this country pays in money and gets nothing back. What this program proposes is a loan where every State has the responsibility to get paid back by the State, so there is no hand-out.

And in the State of California, where only 14 percent of the people have earthquake insurance, where the insurance is available, you're seeing that we're petting bad behavior, as Mr. Roskam says.

So, I would make a point that, as this bill is totally voluntary, it requires each State to have a catastrophe fund that is actuarially sound, that requires each State to step up and take responsibility for the likelihood of disaster in the State, and requires everything to be paid back 100 percent, that this is a far greater situation, a far enhanced situation, than what we have now, which is, as was mentioned before, a bail-out situation, which means that we have a contingent liability on our balance sheet of between, you know, $100 billion and maybe $1 trillion over the next 50 years. With that, I will yield back the rest of my time.

Chairwoman WATERS. Thank you very much. Mr. Baker?

Mr. BAKER. Thank you, Madam Chairwoman. Mr. Swagel, I want to take another run at this from a slightly different perspective. If one were to come to south Louisiana and enter into the insurance business today, and assume the risk for insuring a $200,000 structure somewhere near the coast, I am told by my commissioner that rates in Baton Rouge, pursuant to Katrina, are about $1,000 a year on a $200,000 home.

In the Orleans area, it's about $2,000 now for a $200,000 home. I am told by market activists in the region, however, that those are quotes, they're not real, that you may actually pay $4,000 to $5,000 a year to insure the $200,000 home.

Even if the figure turned out to be $10,000 a year, and it was a $200,000 home, you know, I wonder how many people on the committee would want to put $200,000 worth of insurance out there for anybody on the belief that you were going to get your money back at $10,000 annual premiums, given the fact that out of a 20-year exposure, what's the likelihood of getting a storm that would adversely impact that insured risk?

In other words, if you're really going to price your coverage based on the business risk you're going to assume, isn't that the way the market is supposed to work, that government shouldn't be involved in artificial—the barriers to the performance of a free-working marketplace? And the answer is yes.

And, secondly—you're doing well—that in going forward and analyzing part of the problem in the market function today, and for those looking for remedies, it is currently 54 different varying regulatory entities which you must get approval from, in some form or fashion, before entering into the market and selling the product you design to the consumers you choose to sell to.

And what we have is a collage of regulatory standards from forms and functions, to using paper clips or not, to stapling, to using right colors, to prior approval. So it is not an unregulated market, where someone merely shows up and says, "I'm an insurance guy, here is my product, do you want to buy it," there is a process which you must go through.

Some of this is entirely responsible, in light of protection of consumer interests and not to permit fraud. But one of the contributing factors to the distortion of market function is government regulation keeping persons from offering product at a competitive rate, where many companies will come to a marketplace—it's my observation that almost 50 percent of Americans live within 50 miles of the coastline. It's a huge market. Lots of value. Lots of big condos going to get built, lots of hotels. A big chunk of business.

And if you could get it to where you would have 20 companies in any State writing policies to homeowners, where there might be some competitive opportunity, I would almost guarantee you that the result of that effort would yield a cheaper product for the consumer than an artificial guarantee of a Federal Government reinsurance payment system that we are contemplating today.

It's almost like we are taking the Federal Flood Insurance Program, a governmentally-created intervention into that marketplace, which has sort of worked—not well, and now we're going to put the wind program into effect under the Taylor proposal, but only, of course, where flood insurance is sold, which is all 50 States and every city in the country, but it's a limited thing, and we're going to be surprised when the wind program doesn't work the way we hope, because of the great success of the flood program.

Private market function should assume the risk. They should be free to price. And they should, therefore, compete with others in a similar market to give consumers choice. Now, all of the other ancillary points, to provide for evaluation of safety, and whether or not you're behind the levee or under sea level, all of those things should certainly be considered.

In fact, on the flood insurance maps within the City of New Orleans, it is plainly stamped. You live behind a levee, if the levee fails, you may be subject to inundation. "Please be advised, you may wish to acquire flood insurance." It's on the flood maps, for those who have come to New Orleans and not looked at the flood map, look at it.

And, interestingly enough, a letter out in the press today from the Levee Boards Association of Louisiana, they took great affront that the Administration is going to require that that type—FEMA is going to require—that continued pronouncement on—to homeowners—that if you live behind a levee, you might want to have flood insurance, too. An amazing position for an organization engaged in flood protection.

The point here is that much of the dysfunction in the insurance market today comes from State and local regulatory barriers which preclude involvement from private market participants and result in a high-priced, inefficient system. And in order to cure that problem, the suggestion is being made, "We should put government in the mix, and make it, therefore, more efficient." I find this a striking recommendation.

I would refer members who have not had the opportunity to go back and look at a bill in prior sessions that has been before this committee on many occasions, the SMART Act, which proposed not to take away consumer advocacy from the State level, but to allow the ability to price and sell product, without limitation, across the country.

I have suggested in other meetings that we should have a national product, authorized by this Congress, sold by the private market, that would be priced by the private market, but not be subject to State pricing controls. And I have few takers, because it would allow the free market to work, and for an insurance product to be sold and meet the needs of consumers in a much more efficient way.

Thank you, Mr. Swagel, for your persuasive testimony.

Chairwoman WATERS. Mr. Klein?

Mr. KLEIN. Thank you very much, Madam Chairwoman. And I think this has been very helpful today, for those of us who have been working on this bill for many months.

The mitigation issue, absolutely, is part and parcel of where we're going to move and continue this, because the reason I am very proud to have the National Association of Insurance Commissioners—representing 50 States—supporting this, is because there is a partnership here. Insurance is regulated at the State level. The Federal Government has limited responsibility, and has only jumped in when there was market failure, such as flood insurance and such as TRIA, you know, the terrorism risk issue.

But, generally, it is a State issue, and we certainly want our States to continue to have that full responsibility. This whole mitigation idea, it's going to be different mitigation in Florida than it is in California, or in maybe a part of the country that has some other type of natural disaster risk.

There is a great opportunity—and the reason the idea was initially having the Treasury Secretary in there and his staff, was to involve the consortium to work with the States, and come up with that mitigation. There is not one mitigation plan that is going to be as good for New York City as it is for California. It is going to have to be developed. And if you want to be eligible to opt into this plan, then you have to participate in a mitigation that is customized for that State that will be developed.

This is very common sense, and well reasoned. And, you know, to the extent that none of you have ideas of who should be part of that discussion, we're all ears. I mean, this is just a very common-sense thing. You want to give every incentive to have people who live in a particular State, and governments in those States, to work together to reduce the exposure and the risk. I agree. Congressman Evans, exactly, we agree on that, and again, we're going to want to fully develop that in our manager's amendment.

The second thing I want to point out. There is definitely—some people have not read this bill, based on the comments that I am hearing today.

The idea of where we're at right now—and I think it was expressed by some of the members up here—is right now you have Congress and the taxpayers of the United States fully funding large-scale natural disasters. That's where we're at right now. Most of the time, it's not getting paid back. It's a gift that goes out, and that's it. Every taxpayer in every State is paying for that.

What we're proposing is a much better way of dealing with that. Number one, we want to make insurance more available, using the private—the private market piece of this is Wall Street selling bonds not guaranteed—and Mr. Assistant Secretary of the Treas-

ury, if there is some confusion—because I know he had some notion here that there is a Federal guarantee, or implicit guarantee—there is no intention of that. You can help us craft language which will make that crystal clear.

This is private bonds that are offered by private issuers—private underwriters, I should say—through the consortium as an issuer. No Federal guarantee, nothing on the Federal books to create any obligation. And that is very—by design. We don't want the Federal Government being involved. We think there is a very big capacity—and our next panel will probably talk about this a little bit, what kind of potential capacity. Without having to assess, you know, higher premiums, we can do this in the form of this additional means. So, that's the first piece.

The second piece, if the Federal Government comes in with a loan in this natural disaster, where we, as Americans, want to stand and help a local community, it's a loan. It gets paid back. Sounds like a better deal to the American Treasury, and for every American taxpayer, to be a loan that gets paid back in some form or fashion, than a gift or a grant. I mean, that just sounds logical to me.

So, it seems like we're addressing and doing it the right way, instead of having this gift, and every time there is a natural disaster.

I would just—Mr. Swagel, in your comments, you say specifically, "Government actions that interfere with well-functioning private insurance markets have unintended consequences," and you went on to say, "Federal Government interference in a functioning natural hazard insurance market would crowd out an active and effective private market."

I think you heard from Congresswoman Ginny Brown-Waite, and I think you will hear from a lot of people around the United States, and I ask that you really go out and look into this. And we will be glad to bring you into parts of the country where the market is not functioning. Example, 30 percent is through a government-backed program.

The big issue? Affordability and accessibility. People can't buy insurance. That's not a functioning—we all want competition, but what we're trying to do here is to create competition. If you create a higher end of liability and limit with the private bonds, you will hopefully get competition. That's what we are being told by many people, many experts in the field here.

But, you know, the notion here is to try to fix it, create a solution. I am going to offer, on behalf of Mr. Mahoney and me, to meet with you and the Treasury Secretary and the President, if necessary, to go over all the fine points and the details, to make sure that we can get all your best advice, and so you understand, as opposed to a bunch of us suits in Washington here saying, "Oh, there's not a problem out there."

There is a problem. There is a very big problem in the United States right now, and it needs to be addressed. And we want to try to do it in a very commonsense way that promotes the private market, keeps insurance companies stable and competitive, brings more competition in, will allow affordability and accessibility to homeowners.

Your home is usually the biggest investment you have, and what we're doing right now, because the market is not functioning in many places, we're driving people out. So I hope that you will agree to meet, and you and your senior colleagues will agree to work with us, and to come up with some specific suggestions, and really try to address some of the points that have been stated today.

Mr. SWAGEL. Sure. We have been working with you, and we will be glad to continue to do so.

Mr. KLEIN. Thank you.

Chairwoman WATERS. Thank you very much. Mr. Putnam.

Mr. PUTNAM. Thank you, Madam Chairwoman. Mr. Swagel, I guess you've probably had better days. You know, to my friends from—mostly from Florida, but also from other parts of the Gulf Coast, I can see by the lack of interest from around the country that we have a pretty steep hill to climb, in terms of persuading non-hurricane areas of the need for some form of recipe for correcting what is a failing private marketplace in, particularly, Gulf Coast States, but especially in Florida.

And Mr. Swagel, in your testimony, quoting almost the same line that Mr. Klein quoted, you say that, "Allowing private insurance and capital markets to fulfill their roles is the best way to maintain the sustainability of communities at risk of natural catastrophe. Government interference in a functioning natural hazard insurance market would crowd out active and effective private market."

First of all, it's not an unfettered marketplace, because you have to go before State-elected politicians to get rates to go up or come down. So it's not—it is not a responsive competitive marketplace, it is subject to externalities that are particular in even-numbered years.

Secondly, if that's the Administration's position, what's the defense of the flood insurance program? I mean, if there should not be government interference in natural hazard insurance, then should the Federal Government get out of the flood insurance program?

Mr. SWAGEL. Well, the flood insurance program, you know, it is what it is. There is no proposal to get rid of it. The Administration supports reforms of it. You know, there is all the bad incentives I discussed before to build and rebuild, and then there is the legacy of subsidized rates. So the Administration does support reforms addressing those problems.

Mr. PUTNAM. But you're already pregnant, right? I mean, there is already government interference in the Federal marketplace—in Federal insurance, right?

Mr. SWAGEL. Well, certainly in flood.

Mr. PUTNAM. I mean, I'm an advocate for reform of the flood insurance program, too. I'm just saying you can't make sweeping statements in your testimony when you recognize that there is already some significant intervention in that marketplace.

And then, finally—I mean, I think all of us are trying to find the right recipe here. I hope that you're trying to find the right recipe here, because if you look at Katrina as a model, the amount of money that the taxpayers were on the hook for anyway is enormous.

And I think that the collective thinking, on a bipartisan basis, whether it's this particular instrument or some other, is that, implicitly, the Federal taxpayers will rally to respond to a major natural disaster in the country. And, explicitly, the risk models out there on the right earthquake in the right part of California, or the right hurricane striking the right portion of the Gulf Coast or the Eastern Seaboard, would bankrupt every insurance company and reinsurance company in the world. Right?

Mr. SWAGEL. Depending on the damage, there would be—

Mr. PUTNAM. I mean, wouldn't—

Mr. SWAGEL. A great amount of damage—

Mr. PUTNAM. Going back to 1992, wasn't Hurricane Andrew within 20 miles of bankrupting all of the companies? And, even hitting the Everglades, it almost put them down, and drove most of the companies out of the State of Florida.

So, my fault, your fault, nobody's fault, the pace of development and the value of that development around the country—not just in Florida, not just on the Gulf Coast, not just on the Eastern Seaboard, but in particular areas that are vulnerable to a variety of natural disasters, the market value of those losses could potentially eliminate every private marketplace that's out there.

And so, it seems to me that there is a role here for some blended private/public solution that thinks prospectively about how we can create some kind of risk pool, how we can create some kind of a reinsurance marketplace that does not reward bad behavior, but does recognize that these occurrences will be expensive, and that, ultimately, the taxpayers will be on the hook.

And it seems to me that we have been talking about this now at least since Andrew, and we have gone through a number of Administrations, a number of Congresses in that period of time. And "no" is not an adequate answer. It seems like there ought to be some appropriate mechanism for us to have this discussion, other than the blanket rejection of any of the proposals that are out there. So I yield back.

Chairwoman WATERS. Thank you. Mr. Wexler?

Mr. WEXLER. Thank you, Madam Chairwoman. I think Mr. Putnam makes some very important points, in terms of the—I certainly don't speak for Mr. Putnam, nor would he allow me to—but the sweeping nature, Mr. Swagel, Secretary Swagel, of your testimony is astonishing. The sweeping nature of the callousness and the brazenness is astonishing, only because you represent the President of the United States.

And if I can analyze the President of the United States's position, it essentially is, as you stated at the beginning of your testimony, that the unavailability and the excessively expensive nature of homeowner insurance is largely a result of State regulatory actions.

So, I'm curious, being that I represent the State of Florida, or a portion of it, what State regulatory actions during the last 8 years of Governor Jeb Bush's Administration did we do or not do in Florida that resulted in the unavailability and the excessively expensive—when it was available—homeowners insurance throughout the State of Florida, not just on the coast, but in every internal area in Florida? What State regulatory actions have we committed in the last 8 years that have resulted in this situation?

Mr. SWAGEL. Just to be clear, the affordability challenge, as I said, reflects the risk. Availability is what I see as the result of the unintended State actions. And, here again, I would point to the role of the State insurer in displacing the private market with the rate suppression leading to—

Mr. WEXLER. So this goes back to Ms. Ginny Brown-Waite's question to you. So it's your position that people are not paying nearly enough for insurance? So your—the President's—response to the homeowners insurance crisis in America is that people must pay exceedingly more for their homeowners insurance, correct?

Mr. SWAGEL. No, sir.

Mr. WEXLER. No? So they must pay less?

Mr. SWAGEL. No one wants—

Mr. WEXLER. No? They must pay the same?

Mr. SWAGEL. No one wants to pay more.

Mr. WEXLER. I'm not asking about what people want to pay. I am asking what the President of the United States—what the Administration's position is. Should people pay more? Should people pay less? Or, is it just right?

Mr. SWAGEL. The Administration wants a well-functioning market that supports people's ability to have access to insurance. And in States such as in the Gulf, to have the insurance they need to rebuild, and move on with their lives.

Mr. WEXLER. Is the market functioning well in Florida today?

Mr. SWAGEL. As the result of State actions, it is not.

Mr. WEXLER. Which State actions in Florida have created the inability of the market to function?

Mr. SWAGEL. The State insurer has largely displaced the private market, to become the largest insurer in the State, and is substantially undercapitalized.

Mr. WEXLER. Ah, so the State of Florida had dozens and dozens of insurance companies that were writing policies left and right, and the State insurer in Florida said, "We want in on this business," and crowded out the private market. That's what we did, apparently, correct?

Mr. SWAGEL. I wouldn't put it quite that way.

Mr. WEXLER. How would you put it?

Mr. SWAGEL. You know, as has been discussed, insurance regulation is at the State level. So—and one aspect of the regulation is on rates. Obviously, there are other aspects.

Over time, a pattern of suppressing rates will have the desirable property of lowing the price that people pay, but will affect insurance companies' willingness to write policies. And that—

Mr. WEXLER. So how do you propose—apparently Mr. Klein and Mr. Mahoney, their prescription isn't good enough for you. So how do you propose to create this well-functioning market? Is it simply redrawing the flood maps? Is that going to carry it?

Mr. SWAGEL. I don't have a proposal to create—

Mr. WEXLER. Oh, you don't have a proposal.

Mr. SWAGEL. To solve the problem in Florida. I certainly—

Mr. WEXLER. Do you have a proposal to solve it in Louisiana?

Mr. SWAGEL. I have a diagnosis, which—

Mr. WEXLER. Can we hear—how do we solve the market problem in Louisiana?

Mr. SWAGEL. When—

Mr. WEXLER. Do you have a plan?

Mr. SWAGEL. In these two States, the State regulatory action to suppress rates—

Mr. WEXLER. Oh. So in Louisiana, too, they did something wrong at the regulatory agencies that created the inability to get homeowners insurance. Louisiana is guilty, too?

Mr. SWAGEL. These are the two States in which—

Mr. WEXLER. Florida and Louisiana.

Mr. SWAGEL. —in which the State insurer has crowded out and displaced the private market.

Mr. WEXLER. You used the words, I believe, "People have put themselves in harm's way." I thought we were at the Iraq hearing.

So, is it the Administration's position, essentially, "If you move to Florida or you live in Florida, you have put yourself in harm's way, so we can't help you, and nor should you expect any help?"

Mr. SWAGEL. No, sir.

Mr. WEXLER. No? So why would you use the terminology, "People have put themselves in harm's way," in the context of homeowner insurance availability in Florida, in Louisiana? How is it relevant?

Mr. SWAGEL. People who build a home in locations susceptible to natural catastrophes such as hurricanes—

Mr. WEXLER. Florida.

Mr. SWAGEL. —such as Florida, face high insurance premiums. They face great risks.

Mr. WEXLER. And they have put themselves in harm's way, which, therefore, necessitates a response from the Federal Government that says, "Sorry, we will redraw the flood maps, you're on your way." Correct? That's your position, isn't it?

Mr. SWAGEL. That's not my position, no.

Mr. WEXLER. Then what is? Thank you, Madam Chairwoman.

Chairwoman WATERS. I'm not going to save you. You have to answer that one.

Mr. SWAGEL. Just looking for permission to go on. I will be very brief.

You know, people have to face the consequences of the decisions they make. And one of the unfortunate consequences of living in a place with high risk is facing high insurance premiums. And it's not for me to tell people what to do, but I can diagnose and say that this is the consequence. If we want to help people, you want to make sure you—

Mr. WEXLER. Madam Chairwoman, if I may for 10 seconds, the President of the United States, the position as you enunciate it, is that people in Florida must pay a much higher rate for property insurance. That's your plan.

Mr. SWAGEL. That's not my plan, no.

Chairwoman WATERS. Mr. Wexler?

Mr. WEXLER. Yes, Madam Chairwoman?

Chairwoman WATERS. Your time has ended, and I think—

Mr. WEXLER. Thank you.

Chairwoman WATERS. —the young man did not say it was his plan. He said he had a diagnosis, not a plan. Thank you very much.

Mr. WEXLER. That is true.

Chairwoman WATERS. All right. All right, with that, I am going to call on Mr. Kanjorski to raise whatever questions he would like to raise. And upon completion of Mr. Kanjorski's questions, we will end this panel and then Mr. Kanjorski will take over for the second panel that we will have today. With that, Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Madam Chairwoman. It has been an interesting discussion. I am certain that we have a lot of answers, but I almost feel compelled to come to the Administration's rescue. Would you like me to do that? Take some of the pressure off of you?

Mr. SWAGEL. Oh, sure.

Mr. KANJORSKI. I would feel really bad if it had some impact on you in the future days.

In reality, as I understand what you are indicating, is really the problem that we have always faced in the coastal States and the high-risk States, and that is virtually recognizing that we had an unusual increase in population, because of the pleasures and benefits of living, as Mr. Evans does, in Florida. People go there from all States; I think half of Pennsylvania went to Florida, so I am acutely aware of that fact.

But the reality is that Florida, unlike Pennsylvania, has disasters, climatic disasters, periodically that we can almost trace. And so, as a result, if you look at it purely from a private market situation of supply and demand, the demand for property is excessive, the prices are high, the people arrive, and shortly thereafter the storms arrive, and the replacement and repair of the properties are huge, and the people find themselves incapable of buying private coverage.

And the State officials, incidentally, find it very difficult to allow them to buy in an expensive private market, because it is very unpopular, politically. So, as a result, more government intervention occurs on the State level, premiums are driven down, private market sellers want to leave, and ultimately the void or vacuum gets filled by the State.

I often raise the question in my mind—as a matter of fact, I am one of the least supporters of catastrophic insurance, but my two gentlemen friends from Florida are starting to convince me that we have to do something. And we probably do have to do something, and it is going to be a hybrid that may work out in the end.

But it has always disturbed me that, if I were a private investor, and I wanted to invest $10 million, whether to put that investment in real estate in Miami Beach or put it in Kokomo, Indiana. If I put it in Miami Beach, it probably will appreciate at the rate of 10, 15, or 20 percent a year, so that as soon as I build my building or real estate, I will have reaped a benefit. I can easily sell it, and it will constantly appreciate.

Normally, because I am in a high-risk area, I would have to compensate for that appreciation by paying a high premium to cover my risk. But because that is suppressed, I do not have to pay that premium. So, somebody is subsidizing my position to make my investment in Miami Beach instead of Kokomo, Indiana.

If I make my investment in Kokomo, Indiana, I would be extremely lucky at the time I completed the building or piece of real estate, that it would have equal value to my actual cost of construc-

tion. It probably would drop a little bit, and it may be worth 80, 85 percent of what I put into the property, initially.

But, on the other hand, my insurance rate would be significantly lower, whether it was the private market or the public-involved market, because there are not a lot of hurricanes in Kokomo, Indiana.

So, the question poses itself, why do people not build in Kokomo, Indiana, but build in Miami, Florida? Well, obvious. One, great weather. Two, their physical assets are going to appreciate significantly, compared to the investment in Kokomo, Indiana. You would have to be stupid not to, so the question is, how does that impact the social economic make-up of the country?

And this is in your defense now, listen to this. The reason you want to discourage the subsidization of insurance, and cause the disconnect in population flow that has already occurred in this country, and is constantly occurring, is that it violates basic supply and demand, and violates the free market system.

The free market system says that if you are going to put an investment in a place, that benefit or risk is the price to cover the insurance premium if the loss occurs. If either of those are not in balance, more people will be more attracted to living somewhere like Miami Beach than they should be.

And we ought to discourage people from building on sand bars. That is true, it is self-evident. But the truth of the matter is, we have to find a way of discouraging people from building in Miami Beach. Because, as I understand it right now, if Hurricane Andrew occurred now, the damage would be 2 or 3 times greater than it was when the storm actually occurred. It would be horrific, in terms of how we would pay for that loss, if the identical type storm hit the identical place.

Now, if you are going to have a subsidization, it is a question of who is going to subsidize. And if you leave it up to the private market to subsidize, they will spread it out among their policyholders, countrywide, as well as in Florida. There will be a little higher price in Florida, but in Pennsylvania, and Kokomo, Indiana, the price is going to be a little higher, so they can take that money and cover their losses in Florida if they occur. So, the country would be subsidizing out-of-State for living on the coast, or living in dangerous areas.

Is that good public policy? I do not think it is good public policy for people to subsidize other people, whether it is done by the government or whether it is done in the private sector. If you have government subsidization, either by reducing premiums initially, or by making pay-outs when damages occur, that also is subsidization. The only difference is that if you do it from the general taxpayer base, everybody in the country contributes, probably, therefore, a little bit less, proportionately, than if you did it on the policy basis because the policies would have the property owners pay as opposed to non-property owners.

You can make an argument either way about which is better. Clearly, having all of the taxpayers in the base is cheaper, and having the property owners pay is putting the burden on the property owner class of the country. That may be a slightly fairer way to do it.

But, clearly, in any way you analyze this problem, there is no way that you can escape that living in Florida or in the coastal States, because of the nature of weather, is going to be more costly than living in the interior of the country, or in other areas of the country at less risk. And there is no question as to a need for subsidization, either through government or through the private sector, using the policy prices across the country.

So, what we select really does not matter. Now the question comes down to should we do anything. And the fact that we have ourselves in this position now, I think, strikes a very interesting sociological problem and political problem.

We are now at the problem in Florida that we may have economic discrimination. Poor people cannot pay the insurance, so they cannot live in the nice weather of Florida, but rich northerners can abandon the north and go south, and, incidentally, avoid inheritance tax, which perhaps could be used to subsidize. I just throw that out there, gentlemen, as something that has always disturbed me—that we would change the bankruptcy law of Florida, that you cannot claim your home as a total exemption, but only $750, as you can in Pennsylvania.

We always, in the Federal Government, have given a tremendous subsidy to the State of Florida to allow somebody to build a $10 million home and not lose it if they go bankrupt. But in Pennsylvania, if you have a $10 million home and you go bankrupt, you get to keep $750 and you lose everything else. That is not quite fair, either.

In one moment, Madam Chairwoman, I will close. My conclusion is—and one of the reasons I wanted to participate with this hearing today, and why I wanted to address the panel on it—it seems no question in my mind that the gentleman from Florida did the right thing, and tried to make a proposal.

It may not be absolutely the proposal, but I agree with Mr. Wexler. We cannot take the Administration's position, "There is no solution, other than people have to pay and pay and pay," and end up having economic discrimination. We have to find some hybrid between government, people (rich and poor), private sector insurance, and public insurance, to cover this aspect, to ensure that people can continue to live in high-risk areas. Thank you, Madam Chairwoman.

Chairwoman WATERS. Thank you very much. I would like to thank all of our witnesses who have spent so much time here today. We really do appreciate it.

The Chair notes that some members may have additional questions for panel one, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses, and to place their responses in the record. This panel is now dismissed. Thank you very much.

Ladies and gentlemen, we are about to turn the hearing over to Mr. Kanjorski, who will carry on with panel two from this point. Thank you very much.

Mr. KANJORSKI. [presiding] We will move through this as quickly as we can. I know everybody is itching to get started. We will start

with Mr. Ozizmir, head of the Asset Back Securities-Insurance Linked Securities.

STATEMENT OF DANYAL OZIZMIR, HEAD OF ASSET BACK SECURITIES-INSURANCE LINKED SECURITIES, ENVIRONMENTAL AND COMMODITY MARKETS, SWISS RE

Mr. OZIZMIR. Thank you, Chairman Kanjorski, and Chairwoman Waters, for holding this hearing on H.R. 3355. My name is Dan Ozizmir, and I am manager director of insurance linked securities for Swiss Re.

The Reinsurance Association of America will speak on behalf of the reinsurance industry with regard to the legislation currently before the joint subcommittee. I am here today at the invitation of the joint subcommittee to provide basic information about the workings and mechanics of the CAT bond market. Swiss Re has been a leader of the insurance linked securities market. We have underwritten more CAT bonds than any other broker dealer over the last 10 years.

Five years ago, I testified in front of many of you, and described the insurance linked securities market as a small, but strategically important source of capital. Today, this market not only remains strategically important, but has grown from $7 billion outstanding in 2002, to $32 billion outstanding in 2007, and plays a meaningful role in making insurance more affordable and more available.

Today, many major U.S. property insurers have accessed this market. My comments today will focus only on the current and possible future direction of the CAT bond segment, which represents $12 billion of the $32 billion in insurance linked securities.

Insurers need to hold significantly more equity to underwrite peak exposures, like Florida hurricanes or California earthquakes, than it does to underwrite non-peak exposures, such as a single house fire, or auto accident. Insurers are motivated to issue CAT bonds, because they provide additional multi-year reinsurance capacity at a fixed price, and eliminate default risk.

Why do investors buy CAT bonds? The largest investors include fixed income money managers, dedicated CAT bond funds, and multi-strategy hedge funds. By way of geography, over 60 percent of the buyers are based in the United States, one quarter in Europe, 10 percent in Bermuda, with the remainder primarily in Asia. Spreading individual risk globally will, over time, increase capacity and reduce the cost of reinsurance, as it has in other capital market products.

The primary motivation for investing is to add diversification to an investment portfolio, and to achieve a higher risk adjusted return. Adding CAT bonds or fixed income portfolio reduces the expected standard deviation of the portfolio, improving the overall risk return profile.

In other words, the return stays the same, but the portfolio risk goes down. As an example, historically there has been essentially no relationship between earthquakes and corporate bond defaults. We have, in particular, seen this during the recent turmoil in the credit markets, where the CAT bond prices have remained unaffected.

Here is how a typical transaction would work. First, the insurer would establish a special purpose vehicle to issuer. The insurer then enters into a reinsurance agreement with that issuer. The issuer sells rated bonds, and places the bond proceeds in trust to collateralize or secure the reinsurance agreement. The issuer pays interest on the bond, using reinsurance premiums received from the insurer, and the investment returns on the asset in trust.

If a catastrophe occurs before the reinsurance contract ends, the parties will look at the terms of the reinsurance contract, to determine if the insurer is entitled to recovery. At maturity, the issuer repays any remaining trust assets to the investor.

CAT bonds play an important role in making property insurance in the United States more available and affordable. Most of this new capacity supports U.S. natural catastrophe risk. At present, the $12 billion outstanding of CAT bond issuance offers nearly $23 billion of capacity. The reason this is possible is due to the overlapping coverage provided in so-called multi-peril bonds. Of this, $15 billion of the capacity is used to provide coverage for U.S. CAT risk, and the rest for other geographies, on a global basis.

We expect the CAT bond market to continue to grow, along with the broader market for tradeable insurance risk. The cumulative average growth rate between 2002 and today, as measured by the total amount outstanding CAT bonds, is 35 percent. If the market continues to grow even half this rate over the next 5 years, the amount outstanding would be $56 billion.

And there is plenty of room to grow. The $12 billion outstanding today represents a tiny percentage of the overall fixed income markets. For example, the outstanding amount of U.S. dollar denominated bonds equals $27 trillion. Clearly, these numbers dwarf even the potential insured losses from even the largest hurricanes and earthquakes.

In conclusion, in our view, CAT bonds and related solutions play an important role in assuring the continued availability of affordable insurance. Swiss Re believes this market will continue to grow, and will assist in growing insurance capacity throughout the United States and the world. It is Swiss Re's view that, given time, the private marketplace will adjust, innovate, and grow.

Thank you for the opportunity to express our views on this very important matter. Thank you.

[The prepared statement of Mr. Ozizmir can be found on page 131 of the appendix.]

Mr. KANJORSKI. Thank you very much.

Next, Mr. John Seo, co-founder and managing member, Fermat Capital Management, LLC.

STATEMENT OF JOHN SEO, CO-FOUNDER AND MANAGING MEMBER, FERMAT CAPITAL MANAGEMENT, LLC

Mr. SEO. I thank the Subcommittee on Housing and Community Opportunity and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises for inviting me to testify at this hearing on the catastrophe bond and risk linked securities market, which I will simply refer to as the CAT bond market. My name is John Seo, and I am co-founder and managing member, along with my brother, Nelson Seo, of Fermat Capital Manage-

ment, one of the leading firms in the CAT bond market, with $2 billion in assets under management.

Wall Street invented the CAT bond market in the mid- to late-1990's, in the wake of Hurricane Andrew and the Northridge earthquake. Many people assume that CAT bonds are just securitized reinsurance, or even just a bond issued by an established insurance company seeking coverage. But none of this is true.

Each CAT bond is, in effect, a miniature, brand new reinsurance company, set up to run automatically. This automated company structure is intended to be like one big baseball cap, into which two parties put their money for a wager. Neutral, third-party professionals safeguard the baseball cap, and pay out money according to pre-specified instructions meant to cover every conceivable outcome to the wager.

This marvelous, automated, arms-length construct is necessary for large-scale securitization of risk, because if collateral at risk is not held and dispersed by a third party, the situation can quickly end up in court if large amounts of money are involved.

In the 2 years since Katrina became a household name, the liquid CAT bond market will have tripled in size, from about $5 billion to about $14 billion by the end of this year. Looking forward, even with things cooling down a bit, we might expect a $50 billion market in 5 years, and a $150 billion market in 10 to 15 years.

In the long term, the biggest factor that will drive CAT bond supply is a form of Moore's Law. As you know, Moore's Law, which says that the number of transistors we can put on a square inch of silicon doubles every 2 years, is driving the growth of digital technology. The equivalent of Moore's Law in CAT bonds is that the amount of property value Americans put onto every square mile in key earthquake and hurricane zones is doubling every 10 years.

Yet reinsurance and insurance capital available to U.S. earthquakes and hurricanes does not double every 10 years. It doesn't even come close, as far as I can tell. Therefore, this fundamental and snowballing concentration risk will drive CAT bond supply in the long term.

Globally, across all traditional markets, investment returns are increasingly moving in locked step with each other. This correlation trend threatens to be devastating to institutional investors, who previously enjoyed a tremendous diversification advantage over all but the wealthiest individual investors.

In response to this threat to their supremacy, institutional investors are adding alternative investments to their portfolios by hundreds of billions of dollars every year, in a quest for non-correlation. And, in this regard, CAT bonds are building a great reputation. In this year's credit crisis, CAT bonds performed steadily and well, as was also the case almost 10 years ago, during the long-term capital management crisis.

This has not escaped the notice of institutional investors, pension funds in particular. Pension funds can be gigantic, bold, long-term investors, and they have about $15 trillion in assets, combined. If pension funds want to put 1 percent of their assets into CAT bonds—and that is shaping up to be the case—pension funds alone would end up investing $150 billion in the CAT bond market.

As a whole, pension funds, like many institutional investors, tend to act on a rule of tens, which I describe as, "To be taken seriously, any new market must first be in existence for at least 10 years, and second, grow past $10 billion in size." The CAT bond market achieved both of these milestones this year.

So, we might consider that the next 10 to 20 years' worth of CAT bond market growth is likely to be driven by a single class of investors so large that even a $150 billion insurance industry loss would cost them no more than 1 percent of their assets. Thank you for your attention.

[The prepared statement of Mr. Seo can be found on page 153 of the appendix.]

Mr. KANJORSKI. Mr. Franklin Nutter, president of the Reinsurance Association of America.

STATEMENT OF FRANKLIN NUTTER, PRESIDENT, THE REINSURANCE ASSOCIATION OF AMERICA

Mr. NUTTER. Chairman Kanjorski, and Ranking Member Biggert, thank you for the opportunity to testify. My name is Frank Nutter, and I am president of the Reinsurance Association. The RAA appreciates the opportunity to testify on H.R. 3355. While the RAA does not support this legislation, and has significant concerns with the provisions of it, because we believe it may crowd out the private reinsurance market—we do agree with many of the principles in the legislation, and pledge to work with the committee to improve it, as it moves through the legislative process.

I would also like to commend Representatives Mahoney and Klein for their leadership in exploring solutions that seek to maximize the resources of both the public and private sector in addressing coastal insurance issues.

Notwithstanding the extraordinary losses from natural catastrophes in 2004 and 2005, the private insurance and reinsurance sector proved exceptionally resilient. The record losses for insurers reduced insurer earnings in 2004 and 2005, but U.S. property and casual insurers increased capital in both years, and again in 2006.

After Hurricane Katrina, an additional $41 billion of new capital entered the reinsurance business to support and underwrite U.S. natural catastrophe risk, including $12 billion to $15 billion of new securities for catastrophe risks issued by the capital markets.

We are pleased that the principle of utilizing the private reinsurance and capital markets underlies H.R. 3355. Spreading the risk of natural catastrophes to the private sector, rather than State insurance programs, is the best long-term solution to addressing catastrophe exposure and cost issues.

Most States, in fact, embrace this same goal of depopulating State programs and residual market mechanisms. The alternative to competitive private markets are State insurance and reinsurance programs that encourage State entities to replace or compete with the private sector, by underpricing catastrophe risk. These programs serve to concentrate catastrophe risk in a State, rather than to spread it into the global, capital, and reinsurance markets.

This, in our view, turns sound risk management on its head. If government reinsurance programs do not collect premiums based upon the catastrophe risk of the insurers that transfer risk to it,

those programs will be financed by public debt, and cannot afford to lay off risk to the capital or global reinsurance markets, a principle underlying this piece of legislation.

Reinsurance markets embrace, and in fact, regularly reflect the principle contained in H.R. 3355. Insured catastrophe risk can and should be transferred to the private market, rather than concentrated in these State-sponsored programs. We do not, in that respect, understand why a federally-chartered corporation or consortium is necessary to achieve this. Reinsurance brokers and intermediaries to the capital markets regularly perform the functions described for the proposed federally-chartered consortium.

In addition, States, in particular Florida, have explored a consortium goal of risk transfer of catastrophe exposure among the States. To date, States have chosen not to join together to pursue this. Insurers, reinsurers, and capital markets now serve to assimilate risk among various risk bearers, public and private, as an efficient way to achieve a spread of risk and competitive market pricing. The consortium's underlying finances and value to consumers should be further analyzed.

The authors of the bill are to be commended for the principle that the Federal Government will have no liability under the program, yet it is difficult to understand how a federally chartered corporation or consortium that does not bear risk on its own account can issue securities, and not expose the Federal Government to liability.

It should be expected that the capital and reinsurance markets will require a risk-based rate for assuming a State program's—or a consortium State program's catastrophe risk. In that regard, it's hard to understand how a federally-chartered enterprise—a conduit, as described in the bill—would seem to achieve any savings.

The RAA has significant concerns with Title II of this legislation. We believe that Title II will encourage the creation of State catastrophe reinsurance funds, and unnecessarily crowd out the private reinsurance and capital markets. The principles stated in Title II of H.R. 3355 that reflects concerns of the liquidity of State reinsurance programs is valid, but currently of very limited application.

The Florida Hurricane Catastrophe Fund, the only fund that arguably qualifies under this program, is heavily exposed to debt financing. No other State has a reinsurance fund. Hawaii did have an active reinsurance fund after Hurricane Iniki in 1994, but closed it 2 years later, as private market conditions rebounded.

The bill, in our view, will incent States to create reinsurance programs like Florida's, based upon public debt. With a carrot of low-interest loans from the Federal Government, States will create reinsurance programs which, to date, they have chosen not to. The risk of loss will no longer be spread through the private, reinsurance, and capital markets, but instead will be concentrated within that particular State and its insurance consumers.

The likely effect of the liquidity provisions is to transfer risk from consumers who live in catastrophe-prone areas to Federal taxpayers.

We have offered in our written statement several suggestions for modifications to the bill. I will not take the time to go through them, but I encourage the committee and its staff to look at them.

They certainly include encouraging the Secretary of the Treasury to have a greater role in addressing the financial underpinning of these State reinsurance and insurance programs, and certainly questions about the low trigger that is contained in the legislation of 150 percent of homeowners' premiums. This is a very small event in most States, and would result in borrowing for many events that, historically, have been easily absorbed by the private market, without any disruption in capacity or pricing.

We look forward to working with the committee, Mr. Chairman, and the committee staff, in improving this legislation as it goes forward. Thank you.

[The prepared statement of Mr. Nutter can be found on page 120 of the appendix.]

Mr. KANJORSKI. Thank you, Mr. Nutter.

Mr. Vince Malta, on behalf of the National Association of Realtors.

STATEMENT OF VINCE MALTA, MALTA AND COMPANY, ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS

Mr. MALTA. Good afternoon, Chairman Kanjorski, Ranking Member Biggert, and members on the subcommittees on housing and capital markets. Thank you for the invitation to present the views of the National Association of Realtors, NAR, on H.R. 3355, the Homeowners Defense Act of 2007.

My name is Vince Malta, and I am a Realtor from San Francisco, California, where I am the owner of Malta and Company. Our firm handles real property sales and manages over 300 residential rental units. I was the 2006 president of the California Association of Realtors, and currently serve as vice chair of NAR's public policy coordinating committee.

On behalf of NAR, the leading advocate for homeownership, affordable housing, and private property rights, I want to thank Representatives Ron Klein and Tim Mahoney for their efforts to develop H.R. 3355, the Homeowners Defense Act.

A strong real estate market is central to a healthy economy by generating jobs, wages, tax revenues, and a demand for goods and services. In order to maintain a strong economy, the vitality of residential and commercial real estate must be safeguarded.

Unfortunately, we have heard Realtors in numerous States, not just in the Gulf Coast, but also New York, New Jersey, South Carolina, and North Carolina express concerns about the availability and affordability of property insurance. Their insurance concerns extend beyond homeowners insurance, and include multi-family rental housing, and commercial property insurance.

Insurance is a key component to financing the purchase of real estate. Limited availability and high cost of property insurance threatens the ability of current property owners to hold on to their properties, and slows the rate of housing and commercial investment in many communities. Either of these threats could, in turn, further delay the rebuilding of communities damaged by recent catastrophic storms.

The Homeowners Defense Act has two components: number one, a national catastrophe risk consortium; and number two, a program to make liquidity and catastrophic loans to State or regional

reinsurance programs after a natural catastrophe. Both of these programs would enhance a State's ability to institute disaster mitigation activities, support the availability and affordability of insurance, and help States and property owners recover faster after disaster strikes.

The bill authorizes the Secretary of the Treasury to make liquidity and catastrophic loans to States with qualified reinsurance programs, and in case of catastrophic loans, to FAIR and windstorm plans. These loan programs would help provide consumers access to homeowners insurance by stabilizing insurance markets, particularly after a disaster has struck.

NAR believes that the time has come for Congress to develop a comprehensive natural disaster policy that will mitigate exposure to the risks of natural disasters, and foster the availability and affordability of insurance for residential and commercial properties.

The private sector, government, and individual property owners must work together to address the current insurance situation. A comprehensive natural disaster policy would acknowledge that there must be a team effort, with shared responsibilities, to prepare for and recover from catastrophic events.

Homeowners need to take appropriate mitigation measures, and purchase adequate insurance. Insurance companies need to offer adequate and understandable coverage at fair prices, and pay claims in a timely manner. Governmental responsibilities include protecting consumers, preventing market failures, and ensuring the adequacy and soundness of a central infrastructure, such as levees, damns, and bridges.

A comprehensive policy must address each of these elements. H.R. 3355 addresses one element, preventing failure of insurance markets, of what can be a comprehensive national policy to address future catastrophic events.

NAR also would support legislation such as tax credits to support mitigation activities, and increased funding for infrastructure, two areas outside the jurisdiction of the Committee on Financial Services.

Additional details regarding NAR's position on these and other provisions can be found in my written statement. Thank you again for the invitation to present the views of NAR on H.R. 3355. We stand ready to work with you and the members of the Committee on Financial Services to enact H.R. 3355.

[The prepared statement of Mr. Malta can be found on page 108 of the appendix.]

Mr. KANJORSKI. Thank you, Mr. Malta.

And now we will hear from Mr. Robert Joyce, chairman and chief executive officer of The Westfield Group, on behalf of the Property Casualty Insurance Association of America.

STATEMENT OF ROBERT JOYCE, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, THE WESTFIELD GROUP, ON BEHALF OF THE PROPERTY CASUALTY INSURANCE ASSOCIATION OF AMERICA

Mr. JOYCE. Good afternoon. I am Robert Joyce, chairman and CEO of Westfield Group, and vice chairman of the Property Casualty Insurance Association of America, a national trade group rep-

resenting more than 1,000 insurers. PCI members provide homeowners insurance to more than 35 million American households.

Thank you, Chairs Kanjorski and Waters, and Ranking Members Pryce and Biggert, for inviting me to address you today. We are pleased to have the opportunity to work with you in this effort to develop a solution that works for consumers, insurers, and State and Federal Governments.

When it comes to insuring against the financial devastation caused by natural disasters, all of us share the same goals. We want to reduce the losses from catastrophes by making homes stronger and people safer. We want to limit development in higher risk areas. We want to stabilize markets by combining private market competition with appropriate government participation.

While no insurer can predict how or where an individual loss will occur, the most common and frequent types of losses covered by homeowners insurance policies are very predictable. Insurers can reasonably estimate, from past experience, what percentage of policyholders will file claims, and how much those claims will cost.

Catastrophes, however, present a unique problem. Either no one is affected, or millions of people file claims at the same time. What's more, the financial risk from natural disasters, such as hurricanes and earthquakes, are highly concentrated. H.R. 3355 provides a basis to begin the debate over how we can work to stabilize property insurance markets. Title I of the bill establishes a Federal consortium that opens the door to developing effective ways to utilize innovative financial tools, most notably catastrophe bonds.

While we support this concept, it appears that a centralized repository may result in the establishment of a tax advantaged private market competitor. We would like to work with you on possible modifications to Title I that would achieve the same results, without creating a new Federal bureaucracy.

Title II contains a provision that would make credit financing available to qualified State catastrophe funds, insuring their ability to meet claim requirements. We believe that this liquidity loan program should be one of the key elements of a comprehensive public/private program to address catastrophic issues.

The industry has proven that it can respond to large catastrophes, but private markets may not have the financial capacity to fund mega catastrophes, or to pay claims from a series of very large events in a single year. In these instances, the liquidity facility would offer solvency protection to State catastrophe funds in order to stabilize markets.

However, any Federal program must be carefully structured so that it does not mask the true cost of insuring against catastrophes, encourage reckless development in high-risk areas, or hinder the flow of private—new private capital to the markets. We think it is critical to connect such standards to the creation of a Federal financing facility, in order to provide incentives for States to do everything they can to reduce their exposure to future losses, and attract private capital, before asking for Federal assistance.

PCI believes that the threshold for liquidity loans is too low, and will allow States to look to the Federal Government to pay for catastrophe losses that are well within the ability of the private market and State disaster insurance plans to handle. We look forward

to working with you to develop threshold levels that are more appropriate to each State with exposure to catastrophic risk.

H.R. 3355 will also make loans to State or regional catastrophe funds that are not qualified reinsurance plans, or to State residual market entities. PCI believes that making loans to these entities would allow States to benefit from a Federal loan program without doing everything possible to reduce or prevent losses, and spur private market participation before seeking Federal assistance.

Finally, the bill's provisions do not specify how the loans will be repaid. PCI's concern is that the cost of these loans could simply be passed on to insurers, which could create solvency problems for some companies, following a catastrophic event.

The liquidity facility proposed in this bill has considerable merit, and could play an instrumental role in a long-term solution to America's natural disaster problem. There are other provisions in the bill and other components to a comprehensive approach to addressing catastrophic risk issues that are addressed in our written testimony. We look forward to working with the sponsors and the committee to refine this proposal, so that it best serves consumers and taxpayers. Thank you.

[The prepared statement of Mr. Joyce can be found on page 99 of the appendix.]

Mr. KANJORSKI. Thank you, Mr. Joyce.

Mr. Spiro, on behalf of the Independent Insurance Agents & Brokers of America, Inc..

STATEMENT OF STEVEN J. SPIRO, CLU, CHFC, SPIRO RISK MANAGEMENT, INC., ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA, INC.

Mr. SPIRO. Good afternoon, Chairman Kanjorski, Ranking Member Biggert, and members of the committee. My name is Steve Spiro, and I am pleased to be here today on behalf of the Independent Insurance Agencts & Brokers of America, Inc., also known as the "Big I," to provide my association's perspective on efforts to reform how our Nation insures against natural disasters.

I am currently serving on the government affairs committee on the Big I. I am also president of Spiro Risk Management, Inc., an independent insurance agency based in Valley Stream, New York, which offers a broad array of insurance products to consumers and commercial clients in New York, and approximately 30 other States.

Whether it is the possibility of earthquakes or threats posed by hurricanes, just about every corner of the United States is subject to the effects of a devastating natural catastrophe. Even if your constituents aren't hit directly by natural disasters, when the government provides assistance after disaster strikes, we all pay, as taxpayers.

This unfortunate and regrettable certainty has created what amounts to a property insurance crisis in some parts of the country. I have seen the effects of this crisis firsthand, on Long Island. Within the last year-and-a-half, a number of major insurers have decided that they will not write new homeowners policies. Meanwhile, the commercial marketplace is now seeing policies with sep-

arate wind storm deductibles, as well as new limitations on business interruption coverage.

While at this time I am able, through much effort, to find insurance coverage for my consumers, it is often times at unaffordable rates. I would like to stress that this issue is not simply a Gulf Coast problem, it is a national problem. The same marketplace challenges that have affected coastal areas are now beginning to occur elsewhere.

Along the New Madrid fault line, both a large national and regional company have recently announced their intentions to completely withdraw over time from the residential and commercial earthquake market. The regional company is the largest regional writer of homeowners insurance coverage for independent agents in these earthquake areas, and as many as 70,000 customers could be affected by their decision. These latest developments are further evidence of the increasing national scope of this problem.

In order to effectively prepare for and insure against natural disasters, our country needs a natural catastrophe plan. The Big I is not alone in calling on Congress to act. Both the bipartisan Southern Governors Association and the U.S. Conference of Mayors have adopted resolutions urging Congress to create a reasonably priced national reinsurance program. Copies of both States are included at the end of my written testimony.

Some insurance companies are also recognizing that a congressional solution is needed, and we particularly like to commend companies like Allstate and Travelers, for engaging in this policy debate, and proposing innovative ideas. In specific regard to the Homeowners Defense Act, I would like to thank Representatives Ron Klein and Tim Mahoney for their efforts to address this natural disaster crisis.

While the Big I is not yet ready to formally endorse the Homeowners Defense Act at this time, we do believe it contains a number of provisions that could have a positive impact on the availability and affordability of natural disaster insurance. There are, however, important questions that must be answered.

The legislation contains a number of creative ideas, including a consortium that could lead to some lower reinsurance prices, a loan program to stabilize State reinsurance programs in the event of catastrophe, and the incentive such a loan program would provide for more States to create reinsurance programs. As I mentioned, however, there are also some questions this legislation raises that I feel must be answered.

For example, how many States would volunteer to participate in the consortium, and how many investors would be interested in purchasing these natural disaster bonds?

Can the legislation go further in strengthening building codes for qualified plans?

Should a qualified plan be required to offer commercial coverage, in addition to residential?

Would the 5-year transition allowing FAIR and windstorm plans access to loans crowd out the private market, and should this transition be shortened or altered?

Finally, and the most important question for any proposed solution, how will the private market react? And will this result in increased coverage for consumers?

In short, we believe the Homeowners Defense Act deserves serious consideration. We are hopeful that some questions—the questions mentioned earlier are resolved, and this bill could be part of a broader, more comprehensive solution.

As the committee searches for this solution, we urge you to look first towards the possible addition of Congresswoman Brown-Waite's provisions from H.R. 330. This bill would allow private insurers to purchase, at auction, reinsurance contracts directly from the U.S. Treasury to cover natural disasters. A package that contains a consortium to offer natural disaster bonds and reinsurance contracts, a loan program to stabilize State reinsurance programs, and a Federal reinsurance program that would directly assist the private market, could be an interesting and innovative approach to the natural disaster crisis.

In conclusion, we commend you for convening today's hearing, and hope the committee will act quickly to pass a comprehensive solution to resolve the catastrophe insurance availability crisis. Thank you.

[The prepared statement of Mr. Spiro can be found on page 155 of the appendix.]

Mr. KANJORSKI. Thank you, Mr. Spiro.

Mr. Echeverria.

STATEMENT OF JOHN D. ECHEVERRIA, EXECUTIVE DIRECTOR, GEORGETOWN ENVIRONMENTAL LAW & POLICY INSTITUTE, GEORGETOWN UNIVERSITY LAW CENTER

Mr. ECHEVERRIA. Thank you, Mr. Chairman, and members of the committee. I will attempt to set a record for brevity in these proceedings.

The institute which I direct, the Georgetown Environmental Law and Policy Institute, recently published a report on this topic with a dramatic bright blue cover. The basic conclusions of that report are one, that a major Federal Government intervention in the coastal disaster insurance market such as that proposed in H.R. 3355 would likely have numerous unintended adverse consequences. And, two, the case has not been made that the private insurance industry, working with reinsurers and private investors, cannot succeed in making coastal disaster insurance widely available at fair prices without Federal Government involvement.

Because I think the latter point has been more than adequately addressed by this panel, I am going to focus, in the interest of brevity, on the first point.

The nature of our political system, as well as our experience with the National Flood Insurance Program, suggests that the Federal Government cannot do a good job of supporting coastal disaster insurance prices that reflect the true cost of the covered risks. The financial burdens of disasters and the premiums necessary to cover those risks create a strong, concentrated, and highly motivated constituency seeking financial relief from those burdens.

On the other hand, the costs to the Federal Government—and, in turn, to Federal taxpayers—of providing this relief are dis-

persed, and often deferred into the future. As a result, there is a substantial risk—indeed, I would say an inevitability—that Federal Government involvement would lead to systematic underpricing of coastal disaster insurance, creating a subsidy for development in hazardous areas, and greater long-term financial risk.

The dangers associated with this underpricing of disaster insurance become even more serious when one recognizes the recent upward revisions in projected hurricane intensity and resulting property damage.

These risks are compounded by the fact that, under our Federal system, responsibility for regulating land use is generally assigned to State and local governments, while under the proposed legislation, the Federal Government would backstop insurance.

Under this arrangement, the level of government with the most to gain from development, from increased tax revenues and general economic development, would bear relatively little financial exposure from potentially unwise development, while the level of government with the greatest financial exposure would have little direct authority to limit and mitigate risks. This misalignment of incentives also tends to encourage unwise coastal development, again creating greater long-term financial risks.

In sum, taking into account the unfair subsidies, the irrational incentives for development, and the cost to taxpayers inherent in a major Federal intervention in the insurance market, and taking into account the capacity of the private market to address this issue, our view is that Congress should avoid making the U.S. Treasury the backstop for coastal disaster insurance. While there are undoubtedly some risks associated with relying on the private sector, on balance, the risks to the taxpayer and to the country's general economic welfare appear significantly lower if the business of providing coastal disaster insurance is mainly left to insurance companies and to private investors.

This is not to say there is no role for the Federal Government in supporting the availability of fairly priced coastal disaster insurance, as I have outlined in my written testimony, but it is a very limited role.

In closing, let me say that I am sympathetic to the accounts of citizens, particularly those of low and moderate income, unable to obtain affordable insurance. It seems to me that the problem is a larger one of the distribution of resources in our society, one that could be addressed through revisions to the tax code, or reducing expenditures on a whole variety of things, depending on your politics, including the war in Iraq, or agricultural subsidies in Illinois. But the one solution we should not embrace is that of systematically underpricing insurance policies for coastal disasters. Thank you for the opportunity to testify.

[The prepared statement of Mr. Echeverria can be found on page 88 of the appendix.]

Mr. KANJORSKI. Thank you very much. Well, we still have our two cosponsors here, Mrs. Biggert.

[Laughter]

Mr. KANJORSKI. This may be history for this subcommittee.

If I could very quickly, Mr. Seo and Mr. Ozizmir, either one of you, give me a thumbnail sketch explanation of the bonds, how it is done, who makes the purchases, why, and what risk is involved.

Mr. OZIZMIR. I will cover that. The basic structure of the transaction is as I described before. There is a sponsor, which can be an insurance company, it can be a reinsurance company, or a corporation, who will look to buy protection. That protection will be in the form of a reinsurance contract or a derivative contract, depending upon the trigger for the pay-out.

An SPV will be created, in which investors will purchase bonds issued by that special purpose vehicle. The investors of those bonds will tend to be hedge funds, money managers—specialized managers, such as Mr. Seo, next to me. Those investors will purchase those bonds, due to the non-correlation aspect of them.

If there is an event, there are specific rules about what the trigger is. Some are based upon the industry losses in Florida. Others are based upon the actual loss of a specific insurance company. If those triggers are hit, the investors lose all their principal, and that money goes to the insurance company to pay claims. If there are no events, the investor will get their full principal back, and will receive a coupon over LIBOR for their risk.

Mr. KANJORSKI. What interest rate is the return?

Mr. OZIZMIR. The interest rates will vary widely. Typically, they're between LIBOR plus 300, which is 3 percent on the low end. There have been some bonds issued up to a 45 percent coupon. Typically, we have seen most U.S. perils pay somewhere between LIBOR plus 400, and LIBOR plus 1,000. So, 4 to 10 percent.

Mr. KANJORSKI. Is there a restriction on high net worth individuals who can be the purchaser of these bonds, or can anybody wander off the street or out of a casino?

Mr. OZIZMIR. No. Not anyone can buy these bonds. The purchasers of these bonds are limited to qualified institutional investors, which is $100 million of net worth or greater. It is our view that the current state of this market, that it is an institutional product only. We do not believe that retail investors should be in this market right now.

Mr. KANJORSKI. As I gather, it is not just a little reinsurance company? Everybody who is making a purchase, are they not acting as a little reinsurance operation?

Mr. OZIZMIR. We would agree with the statement that Mr. Seo made, as well. The important thing to think about—and, again, Mr. Seo mentioned this—is that due to the structure of the transaction that is very programmed, it enables investors anywhere in the world, investors that are not experts in insurance, or experts in reinsurance, to actually take on that risk.

By doing that, you expand the capital base from the reinsurance and the insurance industry to the entire capital markets. And, again, it is our view that, as that development continues, the amount will increase, in terms of availability of reinsurance, and that the cost will fall, because you have a far greater base of capital to access.

Mr. KANJORSKI. And for what periods of time do these bonds—

Mr. OZIZMIR. Typically, the bonds are done anywhere from 1 to 10 years, but the typical maturities are 2 to 3 years. And, in fact, I think this is an important point to raise.

In any other capital market, corporations fund themselves over many years. For example, a corporation will do 10-year securities, 5-year securities, and 1-year securities. Because they do that, they have a stable source of capital, in which they have less price volatility, from year-to-year. The insurance/reinsurance industry is interesting in the sense that all contracts are renewed each year. We certainly believe that the term aspect of the CAT bond market will allow, over time, the cycle and the volatility of insurance and reinsurance rates to be minimized.

Mr. KANJORSKI. There is a sort of junk bond rate, then?

Mr. OZIZMIR. Yes.

Mr. KANJORSKI. Okay.

Mr. OZIZMIR. Typically, the notes are, you know, single B, a double B is the most typical rating. You know, some deals are done with investment grade ratings that are—where very large events would be required to trigger it. Others are so high in risk that they have no rating. They're really more like equity risk.

Mr. KANJORSKI. Very interesting. It takes an investment banker to come up with an idea like that, does it not? Very good.

Would it be fair for me to say that most of the panel is in favor of the legislation, with the exception of the gentleman from Georgetown?

Mr. NUTTER. Mr. Kanjorski?

Mr. KANJORSKI. Oh, reinsurance.

Mr. NUTTER. But even our objections to the legislation are with the caveat that there are many principles, particularly the reliance on the private markets, that we endorse. And we have suggested specific changes to the legislation to try and improve it.

Mr. KANJORSKI. The one thing that disturbs me about the bond question is what are we going to do to curtail the amount of development, the location of development, and the methodology of development, if we just throw it into the capital account?

You know, is Florida going to end up with 40 million people? In my prior speech, I discussed that fact that if you look at the normal principles, you get a control of population by the cost of living in an area, and eventually it becomes prohibitive.

But if we put a fast fix in where we can sell junk bond rated securities, what is going to inhibit Florida from further densifying, or other States? California is probably another example.

Mr. NUTTER. Mr. Chairman, it does seem to me that all States should look at consumers who are funding these kinds of programs, whether they're public or private, with a sound basis of risk assessment, and the risk that they're exposed to. Insurance premiums are a great messenger to people about the cost associated with the decisions they make. And so, risk-based premiums, or risk-based reinsurance premiums, seem to be a fundamental feature.

I think we would agree with the various statements that have been made that there are people with low or fixed incomes for whom the cost of their insurance has become difficult or prohibitive, and that the States and the private sector should be looking at solutions that address that specifically. In other words, look at

the consumers of insurance, to see if we can find some solutions for those people.

But there obviously are people for whom the cost of their insurance is a consequence of the decision they made, but they also may have the resources to pay for the cost of that decision.

Mr. KANJORSKI. So, some subsidy for the snow birds who moved to Florida 20 or 30 years ago, that their pensions or individual net worths cannot afford the insurance has now occurred—that is what you're talking about, as compared to the independently wealthy people down there, let them handle the full burden?

Mr. NUTTER. Well, it's consistent with the principles of the legislation being proposed that you're looking for sound economics, that the capital markets and the reinsurance markets that are part of the solution being proposed here are likely to expect a risk-based premium for this. And loans, or some sort of facility that does indeed make this more affordable for these funds, need to reflect the quid pro quo.

What does this do to help the consumer at the consumer level, if in fact you're going into the private markets and expecting the private markets to price this on a risk-based basis? Some kind of government role related to consumers that have affordability problems needs to be incorporated in State programs or a Federal facility of some kind.

Mr. MAHONEY. Mr. Chairman, would you yield?

Mr. KANJORSKI. Yes.

Mr. MAHONEY. Yes, one of the things I would like to point out is that—to make sure that there is clarity on this point—and that is what the program does is it requires that each State that volunteers to go into the program have an actuarially sound catastrophe program, so that a State like Florida would have the responsibility to have their own CAT program. Today, that number is about $28 billion, and gets us to probably maybe a 1 in 100 year kind of event.

States like, you know, North Carolina, their actuarially sound responsibility might be, you know, $1 billion or $6 billion, depending on what it is. So this idea that somebody is subsidizing the State of Florida is not accurate, because in each State there would be a responsibility to have a catastrophe program funded by the State and the citizens of the State before anything happens with the Federal monies. So, this concept of subsidization, it just really doesn't occur in this bill.

Mr. KANJORSKI. Okay, well, my time has expired. Mrs. Biggert.

Mrs. BIGGERT. Thank you. Just a little bit more on that. Mr. Seo, it seems like we're at a pivotal point in the CAT bond history. The point at which these bonds are becoming mainstream, it's not going to be—institutional investments.

How would the Federal Government involvement or competition in the CAT bond market affect this emerging market?

Mr. SEO. I'm not sure how to answer that, because I'm still not clear on what's being proposed. But from what I can understand, from what I can see, I think that the effects, you know, could be positive, could be negative, but limited, either way. I don't really see any—nothing really jumps out at me that says it can be a complete disaster for the private sector.

Mrs. BIGGERT. Okay.

Mr. SEO. And nothing really jumps out at me that says, you know, this is exactly the spark that we need to get it going, either. Does that answer your question?

Mrs. BIGGERT. I think so. Maybe if Mr. Ozizmir—could you comment on that, too?

Mr. OZIZMIR. Yes. I think a lot of it will depend upon how the bill is executed. And, specifically, I am going to talk about, I think, Title I, which talks about the consortium.

I think the way I try to get the committee to think about this is that in both cases we're saying there are going to be capital market investors with risk adjusted—actuarially sound and risk adjusted returns. So, the question is, if you're an investor like John Seo, and you're being offered two CAT bonds, one from a U.S. primary insurer or reinsurer, and the other from this consortium, you know, what would make you buy one over the other?

And I think the questions will come down, obviously, to pricing. But I think a lot of it will also come down to the controls and disciplines within those programs.

For example, if you are a U.S. primary—pick Travelers, or any one specifically—when you issue your bond, you will go to investors with the bankers, and tell them about your program, how you underwrite risk, how you do claims, your track record. And you will talk about your incentives, your alignment of interest, that it needs to be a well-run program, and claims need to be handled appropriately.

Now, if bonds come out of a consortium, in some sense, since there are so many different insurers, maybe that's a positive, it's slightly more diversified. But the investors will ultimately need to believe that the way that consortium is run, the way the State fund is run, the way prices are done, is robust and will stand the test of time.

I think that if, in fact, the investors believe both stories are equal, then the pricing will be similar. If they believe one program is run better or worse, then clearly the investor capital, which is completely free, will ultimately go to the program that they think is better run.

Mr. KLEIN. Congresswoman Biggert, would you yield for a second on that?

Mrs. BIGGERT. Yes, I yield.

Mr. KLEIN. Yes, just a—part of the thinking, and part of the discussion we had in the research in this—and we spoke to the Chicago Mercantile Exchange, some of the professionals there, and what they said the standardization is what they're looking for. They think that helps the market.

But, ultimately, if there is more competition, I think that's good. Competition is good in any field, and obviously in the bond market, there is nothing wrong with it, either.

The other thing that—there is some question of a possible good thing is this may create more liquidity and more trade opportunity. They are saying that they haven't had enough there to make a huge market yet, but they think that if the bonds really start taking off, you are going to have a very big market. And the trading

opportunity is what really becomes interesting to the investors, as I understand it—you may want to comment on that.

But I think that's what we're trying to drive this toward, is more investor activity and interest, and hopefully more bond interest.

Mrs. BIGGERT. Does it make any difference, then, that the consortium would be, you know, created by statute, and would, you know, securitize the State catastrophic risk in the form of bonds? I just don't know how the competition works, when you have one by statute and one by—

Mr. KLEIN. Well, we're not trying to influence it, either way. We are told that, you know, they're going to compete, and I think that, ultimately, the best way to do this thing would be to let it evolve, and let the market really sort of run this thing, and be successful that way.

Mr. SEO. May I comment, please?

Mrs. BIGGERT. Yes, Mr. Seo.

Mr. SEO. Absolutely competition on the investor side. But as Dan was saying, there is also competition on the bond side. And there is a concern that if you're off on the terms that you're offering, then you could get very little investor interest for seemingly a very trivial thing.

So, it is a double-edged sword. With all due respect to Congressman Mahoney, it is true that Florida has always supported the principle of actuarially sound rates, but I will give an example of something that I'm talking about that could be a problem.

Recently the State of Florida has decided to adopt its own model for calculating what that is. Now, these models—I mean, no one model necessarily is better than another. So I think that the Florida model is well within its right to come out and say, "I think this is an actuarially sound rate." But it just happens to be their model, and not the market's model, what we're using. And since one thing is not better than another, you know, you could argue all day long about it. But in a market, they're going to go off the market model.

By the way, if that market model was giving a lower risk than the State of Florida model, they would still go off of that. But it just so happens that the Florida model estimates the risk at roughly half of what the market models do. So that disconnect alone could result in a consortium that collects risk, comes out to the market, and doesn't place one dollar of the bonds.

Mr. MAHONEY. Can I say just something? Would you mind yielding? We happen to have the expert from the Florida insurance commissioner here, and he pointed out that you're incorrect in that statement, that Florida uses an average of four private sector models. And so they do not have their own model, they are using an average of the four private sector models.

Mr. SEO. Well—

Mr. KANJORSKI. Let us try and keep this orderly now. We have an extension of time here, but Mrs. Biggert's time has expired. Ms. Waters?

Ms. WATERS. Allow me to just yield my time to Mrs. Biggert, so she can continue that line of questioning. I am interested.

Mrs. BIGGERT. All right. Mr. Seo, if you would continue, then?

Mr. SEO. Yes. Well, Congressman Mahoney, it's true. I mean, Florida—actually, I believe—I thought it consulted even more mod-

els than that. They take any model that's valid out there. But, in the end, again, right or wrong, the Florida numbers that are coming out aren't what the market is going off of, and there the argument lies.

On a fundamental basis, stepping back, I don't have a problem with anybody in CAT risk disagreeing with each other by a factor of two. That's easy to do with these models. So I think reasonable people can disagree with that. But then, it comes down to a market transaction that has nothing to do with these types of philosophical judgements.

So, you know, the anxiety that a civic-minded market professional would have is that we would be in an awkward situation where, fundamentally, what the State of Florida was saying is it thought the actuarially sound risk is—is fine. I don't actually have a problem with that. But on a market execution basis, I can't execute there.

Effectively, the rest of the market, right or wrong, is going to be adopting these other market actuarial rates and paying on them. And I have an obligation to my clients, my investors, to put capital where it's going to have the highest return. I'm putting you in competition with other bond opportunities.

Now, if the State of Florida can actually come around to that understanding, that to tap these capital markets they're going to have to go with certain market conventions, even if they disagree, then I think we can have a really nice situation down there. But that one single disagreement alone, you know, where everything else is beautiful, can completely kill the effectiveness of the program. And nobody wants to see that, of course.

Mrs. BIGGERT. Thank you. We will look forward to more discussion of this. And I yield to Ms. Waters.

Ms. WATERS. Thank you very much. There was a question that has been nagging at me for a long time, and some discussion occurred today, relative to the subject matter that I am concerned about.

There was some talk about mitigation, and—mitigation in the bill, and there was some more discussion about not allowing people to build in certain areas. I thought about restrictions on building in certain areas, not simply because of floods, but because of earthquakes and other kinds of potential hazards.

What is the thought from any of the panel members—and maybe we will just go to anybody who would like to answer this question—what is the thinking about public policy that would go in the direction of prohibiting the building in larger areas than we ever really thought about doing? Any discussion in any of the industries about that?

Mr. MALTA. Chairwoman Waters, there has been a lot of discussion locally and at regional levels regarding just that.

And in California, for instance, in dealing with earthquakes, "Earthquakes don't kill people, it's buildings that kill people," and it's mitigation measures that, if you're going to build in a certain area on a certain soil, that you have to compensate for that. Rather than prohibiting building in soft soils, you have to put a floating foundation, or you have to do some measure that will protect the building and human life, in the event of an event.

So, rather than banning, they look towards technology that will allow building, but do it in a sensible manner that protects property and human lives.

Ms. WATERS. And there is substantial technology that can mitigate against disaster?

Mr. MALTA. So we are told, but we haven't had a 1906-type earthquake happen on a 60-story building. But we are told by the experts that these matters have been taken into consideration in the construction of these properties.

Ms. WATERS. Thank you very much.

Mr. NUTTER. Could I?

Ms. WATERS. Yes.

Mr. NUTTER. If I could also comment, building codes are implied in all of this. The legislation that has been offered has, in fact, placed upon the Secretary of the Treasury some authority to see that States have building codes that are appropriate for the risk, and enforced building codes as a critical feature of this.

And as I mentioned, I think before you came back in the room, the insurance premiums should be risk-based, because they do send a message to people about the decisions they make, whether they adopt certain mitigation features, or whether they place properties in harm's way. That's a message that consumers should get about the cost of the decisions they make.

The legislation does offer a feature that does focus on appropriate building codes, so that you can get appropriate development.

Mr. SEO. May I make a comment on your question? Let's say that this legislation goes through, and the CAT bond market comes through. The price signal that we're talking about that acts as a—that helps actually keep areas safe by sending a signal that it's dangerous, will go away. The prices will go down.

And I have thought about this, and I think that is what you are asking. Let's just say that, for some reason, the insurance is cheap, even in these really risk areas. And the only thing I can think of is that there is an old model or situation—for this situation, and it's just fire insurance. I mean, the modern insurance industry was created because entire cities were burning to the ground, but yet the cities kept growing.

And so, what happened is that we decoupled the price signal for insurance from the danger signal. So we just have fire codes. So, even to this day, even though fire risk may be low, we limit the number of people that can occupy a commercial room or auditorium, etc. And I think that you might end up getting the cost signal. Again, but it's all poured into safety, not for the cost of capital.

But I think that we are about to enter a phase of development when we can't depend on the cost of capital, the high cost of capital, to signal danger. We just have to have a separate public policy that is completely analogous to what we use for fire codes.

Mr. ECHEVERRIA. The Sigma Xi organization, which has been looking at the global warming issue, issued a recommendation that governments consider establishing a prohibition on development within a meter of elevation of the sea, on the theory that global warming is on the rise, and we need to effect some kind of gradual retreat from the shore.

And it seems to me that as a matter of wise public policy, in addition to hardening structures, and securing them as much as possible against damage, it's appropriate to think about moving development out of harm's way. That inevitably raises the issue of property rights.

The U.S. Supreme Court, about a decade ago, famously in a South Carolina case, struck down as unconstitutional South Carolina's effort to draw a line along the shore, which they intended to revive as the shore retreated. The court was narrowly divided on that subject. They were not, I think it's fair to say, fully aware of the risks of global warming, and the rationale for South Carolina's policies.

But I think one of the interesting questions that will have to be confronted, if we think about a policy of requiring retreat from the shore, is how to deal with property concerns.

Ms. WATERS. Thank you very much.

Mr. KANJORSKI. Thank you, Ms. Waters. Mr. Campbell?

Mr. CAMPBELL. Thank you, Mr. Chairman. And I have been kind of listening in and out all afternoon, so I apologize in advance if this has been asked and answered.

But being from California, in California we have a thing called the California Earthquake Authority, which a number of you have addressed in your statements. And that is a government-sponsored risk-sharing pool, as you all know. But in California today, only 15 percent of all homes carry earthquake insurance through the California Earthquake Authority or through private entities, and there are a number of private entities that do offer earthquake insurance. My personal residence is insured—I have earthquake insurance through a private entity.

What is this bill going to do, or what's going to be different, to change that kind of dynamic? Because if an earthquake—when an earthquake hits California, 85 percent of the homes that go down or are damaged are not going to be insured today, in spite of the availability of both the government-sponsored program and a number of private insurance efforts.

They are going to come here, and they are going to say, "Help us," and we helped a lot of people in a lot of other States, and even a fiscal conservative like me is likely to say, "Well, we ought to," because we helped a lot of other States, and not California, so—

Mr. KANJORSKI. Maybe I can just ask a question here. Why is it not mandatory by the mortgagors, that earthquake insurance be had?

Mr. CAMPBELL. It is not. I can't—

Mr. KANJORSKI. In Congress, here, we mandated on flood insurance. If you have a mortgage of a federally-insured institution, you have to have flood insurance.

Mr. CAMPBELL. Yes, it's not. I can't answer as to why, but it's not. Anybody have any comments? Because I will tell you, I believe we need—we ought to have something in natural disaster.

I mean, we also have issues—we have mud slides in California. Those are completely uninsurable. You cannot get insurance for them anywhere. But they happen, they happen every few years. People lose their homes, and there is absolutely nothing they can do, because insurance is absolutely unavailable on that par-

ticular—I am told, from the insurance industry, because of adverse selection, which I am sure is probably the case.

But—so, we have situations—particularly the earthquake, which is obviously a much bigger thing—where, how do we know we don't do this, and we have the same sort of situation?

Mr. OZIZMIR. I would like to take a couple of comments on that, for just a part of the question you have.

The CEA program is actually substantially supported by the CAT bond market right now. I think the implications of that were that when the post-Katrina crisis happened in the insurance/reinsurance area, that the CEA did have some term capacity locked up, the had some multi-year transactions, so that they did not see an immediate move in those rates. Additionally, the capacity in the CAT bond market did help mitigate the increased costs that did, you know, occur in that program, but were much less than they would have been.

So, I think that it's a good example of some of the benefits that the CAT bond market can provide. But that, in itself is not, you know, necessarily fundamentally going to immediately change the situation.

Mr. CAMPBELL. Whoemver else wants to answer—

Mr. SPIRO. If I could make a comment?

Mr. CAMPBELL. Yes.

Mr. SPIRO. My response would be if California has a qualified program, I think the loan provisions of this bill would help.

Mr. CAMPBELL. Because?

Mr. SPIRO. The liquidity in the catastrophe loan provisions would be available to help in that situation.

Mr. CAMPBELL. Okay.

Mr. MALTA. But one would wonder why you would do that, the government would do that, when, in fact, you have a program in California that, unfortunately, is not meeting all the consumer needs that should be there, but is, in fact, as Mr. Ozizmir was saying, is a prototype that works.

They do aggregate risk, earthquake risk. It is laid off into the reinsurance and the capital markets, just as this bill, the principle of this bill, provides. It is a workable prototype that's, unfortunately, not being used by all the people that—but it's an interesting public/private approach that does, in fact, achieve a goal that is a fundamental principle in this legislation.

Mr. CAMPBELL. Okay. Let me get to one more question before my time runs out. I do think it's just an interesting thing to look at, and figure out, because it has definitely not solved the problem in California. And the only reason you haven't heard about it is because we haven't had a major earthquake in a while. But when we do, then, you know, again, it will happen.

But the second question I wanted to ask was about—and for Mr. Spiro, particularly, but anybody else who might want to comment, it's about the Liability of Risk Retention Act, which enables people to do self-insurance pools for liability insurance. And GAO has said it has been effective in reducing rates, and that sort of thing.

Should we extend that sort of—have a Liability Risk Retention Act to property insurance, and to allow groups and different people

to pool together for self-insurance on that, and would that be something that could help in this situation?

Mr. SPIRO. That's a good question. The Big I has not formally taken a position on risk retention groups yet. But we do have some serious concerns that I would like to share with you.

Risk retention groups are not subject to State guarantee funds, State guarantee fund protection, like traditional insurers. Additionally, there have been some insolvency issues with risk retention groups. Due to these consumer protection concerns, we would caution against their use for natural disaster risk.

Mr. CAMPBELL. Isn't it better than nothing, which is what 85 percent of Californians have right now?

Mr. SPIRO. Sometimes something is better than nothing. I would have to see the specific provisions before I brought it back to our government affairs committee.

Mr. CAMPBELL. Okay. Anybody else want to comment before my time expires? Mr. Seo?

Mr. SEO. Yes. Until last year, a California earthquake was the largest exposure in the CAT bond market, so we have a good $5 billion of it right now. We don't have a problem with it, it's just that there is not so much supply because of the penetration problem you're talking about.

And I believe it's because it's not the dollar amount of the policy that's in question—it's around $600, on average, per household—it's just the coverage.

Mr. CAMPBELL. The coverage, yes.

Mr. SEO. So, the coverage is being rationed. So, if this were to help, what would happen is that you would have a lot of Florida hurricane risk, or U.S. hurricane risk coming out to the market. The market would want to complement that with more California earthquake risk. It would need that.

So, it would actually provide the opportunity for the CEA to change the terms of its mini-policy, and turn it into a more full-blown policy.

Mr. CAMPBELL. In your estimation, that would either help the coverage or the rates?

Mr. SEO. I think it would. I think that your penetration rates would go up, you know. Right or wrong, you know, I'm sure you know people that went through the Northridge earthquake. And so, they just apply the terms of the mini-policy to the claim that they had made.

And so, like I know a person that had a claim that was around $80,000. She applied it to the mini-policy, it's $7,000. So, even like I said, even if it's not quite right, the mini-policy is worth 1/10th of what the normal policies were. So, even though the actual dollar cost of the policy is reasonable, which it is, the coverage, at least by perception, isn't adequate. So, nobody knows, but I think that the solution lies along those lines.

Mr. CAMPBELL. Thank you. Thank you, Mr. Chairman.

Mr. KANJORSKI. Okay. Mr. Klein is next.

Mr. KLEIN. Thank you, Mr. Chairman. First of all, thank you all for being here today. Again, the second panel has provided a lot of good insight.

Congressman Campbell, I will spend some time with you to go over—you know, we believe that part of the innovation here is to try to spread the risk. And there are different types of risks around the country. And I think what was just explained a few minutes ago is if you take hurricane risk—which is not just limited to Florida, it goes all the way up the East Coast and the Gulf Coast—you have earthquakes, and mudslides, and lots of different things, the scale is different, the damage is different, the probability may be different.

But if you put them all in, it may do what insurance is supposed to do, and that is create a better model, which, in turn, over time, may—we are focusing on accessibility of product and price. So that's what the goal is trying to accomplish.

Mr. CAMPBELL. And if the gentleman will yield for just a second—and I am very interested in that, and I get that. I think the fundamental question for me is does this really get to that.

Mr. KLEIN. Sure.

Mr. CAMPBELL. And, in the end, how are we going to get people to buy it and/or hold them accountable if they don't? I mean, in the end—and it always sounds harsh to say this—but if you provide a government insurance or reinsure, whatever, sponsored insurance program, and people choose—people who choose not to pay the premiums still get benefits from the government, then you have a disincentive to buy the premium.

Mr. KLEIN. And this is not a government insurance program.

Mr. CAMPBELL. And I don't want to take up all your time, but thank you.

Mr. KLEIN. The other thing I want to mention—because there is a lot of discussion about where you build properties and improvements, and all the rest of that, I think everybody understands that these are local government issues. The Federal Government is not going to start creating planning and zoning commissions in here in Washington, to decide what gets built.

However, where we can use our influence a little bit is we can say, "If you want to participate in this model, and you want to be eligible, you may have to do certain things." Because, otherwise, we have no ability to say to the local government, "You can't build here." I mean, we have coastal construction line issues on the coast, and other things, but there are limitations of what we can do.

But I think we can certainly have a draw-in by, "Say, listen, if you want to participate"—and that's where, in the first panel discussion, we talked about, you know, there needs to be discussions with codes. Different in California than in Louisiana, you know, different risks to protect against. So I think we will certainly talk about that, and get everybody's input on making sure that that mitigation factor is brought into this, and is a condition.

You know, I think the rest of this is I think we have to read this carefully. We obviously want Wall Street, and the people that sell the bonds—we're not forcing this on anybody. I mean, if this works, it's going to work because there is a market for it, and because it has the consequences we are trying to create.

But, you know, part of the assessment up to this point is, "Is there capacity?" I am hearing from—and we've heard from others,

as well—there is a national—there is risk catastrophe bond capacity. It is growing, and that may be something that can build capacity that shifts the risk from policies over to a private source, and that's a good thing, instead of having, you know, more public—we don't want the government to be involved, we would rather have the private sector involved. And if there is more capacity there, that's a positive thing.

But I am just going to end there, by saying—by thanking everybody, and thanking the Chairs for holding this today. This is a work in process, as we have suggested. It is complicated. But we have to move forward and come up with something that will work, will help the homeowners, you know, work with the industries, and make sure that we solve this problem. So, thank you again for your courtesies.

Mr. KANJORSKI. Mr. Mahoney?

Mr. MAHONEY. Thank you, Chairmen, very much. A couple of things. A real quick question for Mr. Seo.

In terms of the CAT bond market, on those interest rates that you were talking about, does that presume that the holder of the bond gets repaid in all instances, or do they take the risk of losing their capital, should the bond be—the CAT bond—

Mr. SEO. Oh, yes. All the capital is at risk, all the principal is—

Mr. MAHONEY. So you can—so, over a 10-year period of time, you can actually get people to take these bonds at a 10 percent over LIBOR rate? Is that what you're telling me?

Mr. SEO. Oh, for a 1 in 100 year risk, I think you could do less than that.

Mr. MAHONEY. Yes, because, you know, it gets to the real issue here, you know. What no one has talked about here is what is wrong with the market. We have people who are on my right side of the table who are very concerned about independent agents, and things like that.

I think we all agree, as a panel, that everybody that owns a home should be able to have affordable homeowners insurance. Is that correct? Okay. Does everybody understand that the average family of four in the State of Florida makes $42,500 a year? Does that sound reasonable?

So, the question becomes one of what's the problem, right? What's the problem with the market? And the State of Florida has come in, and they say that a 1 in 100 year event, we're looking at potentially $70 billion worth of liability. And right now, with their own efforts on the State CAT fund, $6 billion in company retention, working with reinsurers today, we're getting to about $38 billion of coverage. That leaves, by my math, $35 billion that we have open-ended liability.

And what we found out, after they did all these heroic things in the State of Florida, that a lot of these companies were taking advantage of the lower reinsurance rates, and they were using it to buy higher cost reinsurance.

But at the end of the day, whether they be your CAT bonds—which only is $15 billion of a $35 billion problem in the State of Florida this month—and the reinsurance business, where, depending upon where the risk that you're buying, whether it be a 1 in 2 year risk at 80 percent, or a 1 in 100 year event, which could

be a 10 percent premium, $100 million on $1 billion, gentlemen, it's broken.

Because when you add up all these things—I'm an old manufacturing guy, we call this cost of goods, right? These are costs, and then you have to earn a return on top of that. When you take all these costs to try to cover a $70 billion event using your products, and you divide by the number of homeowners insurance premiums out there, guess what? You can't afford it.

So, my question to you is, what can you guys do, instead of costing me a 1 in 75 year event in the reinsurance business $200 million per $1 billion covered, what can we do to lower that to something that is affordable? Because that's the problem. Nobody wants to be in the business today, but until you cover that liability, then the market is going to be broken. And it is broken. People can't get insurance in Florida. If it wasn't for Citizens coming in, there would be no private market. There would be no market for any kind of insurance.

So, I hear what you're saying. But the question, again, is that it's too expensive. So what are you guys going to do in your industries—CAT bonds and reinsurance—to make your product affordable, so that people can afford the insurance?

Mr. KANJORSKI. You could do what the Congress always has done, we could pass a law outlawing hurricanes.

Mr. MAHONEY. That would be good. All right, why don't we start out—I would like to hear from Mr. Ozizmir first, if he could be brief.

Mr. OZIZMIR. I will take a first crack at that. I think one of the things that I would like to discuss is the actual composition of the CAT bond market, and I think—

Mr. MAHONEY. I don't—we don't have time to go into that. I mean, what can you do to lower the rates?

Mr. OZIZMIR. Well, I think—and the point would be this. In the CAT bond market, there is a big difference between the rate for non-peak risk and peak risk. For example, if you have a Mexican quake with a 1 percent expected loss, you will pay 2 to 3 percent. If you have U.S. hurricane risk at a 1 percent expected loss, you will pay 6 to 8 percent.

The reason that's important is that one of the reasons why there is a much higher rate for peak risk is that the insurance and reinsurance industry has a certain amount of capital. And if they are going to risk a significant amount of that capital in one location, they will charge a higher rate.

My point would be a lot of people talked about the global capital markets being $50 trillion. If, in fact, the risk, over time, is spread throughout the entire global capital market, the $50 trillion, instead of just the insurance/reinsurance industry, we would have very good reason to expect that that extra premium that the people in California and Florida are paying, versus someone in a non-peak risk zone, will compress significantly. That is ultimately—

Mr. MAHONEY. Yes, you know, but the problem is that—I'm an old venture capitalist, right? When people put up money and they risk everything, you know, you're not going to do it for 8 percent or 10 percent. I mean, in the reinsurance industry, that's what you guys are basically doing. You're basically getting contracts with

people and institutions and saying, “We need to pull down on these lines. You give up everything, but you get a high return.”

Mr. OZIZMIR. I understand your comment, but—

Mr. MAHONEY. I am asking—now I am talking to Mr. Nutter.

Mr. OZIZMIR. If you don’t mind, one comment is that the situation I described, where investors today are earning 2 to 3 percent and risking everything in the CAT bond market—

Mr. MAHONEY. I would argue—I hear what you’re saying, but I would argue that’s the reason you’re at $15 billion of something that may be a $1 trillion liability. It’s—we have a $35 billion liability today, which swamps the CAT bond market as it is structured today.

But, getting to Mr. Nutter, I mean, what can we do to get the cost of reinsurance down, so that people can afford the product? I mean, what we do in this bill is we try to set a cap on the insurance company, what the liability of the insurance industry is, so that we can make prices affordable. But—and we’re trying to do it at a level that encourages, to a certain extent, the insurance companies continue to buy your industry’s products, because we think that we need to support the industry.

But, you know, the fact of the matter is that everything to date hasn’t worked, because we have unfunded liability. And the reason why we have unfunded liability is because it’s too expensive. So, what can we do to encourage, you know, you to—you know, how do we get the rates lower, so that we can afford it?

Mr. NUTTER. Well, if I could comment that the experiment that Florida has engaged in, where it not only created a hurricane catastrophe reinsurance fund in 1993, 1994, expanded it, as you know, this year at rates charged to insurance companies at 1/6 of what the private market thought appropriate. So, the experiment that you hope to achieve is what Florida is engaged in.

Mr. MAHONEY. Yes, I didn’t hope to do anything, that’s not—you know, I represent a district in Florida, I don’t represent the system.

Mr. NUTTER. I understand. My point was going to be that it doesn’t seem to be working. I mean, that’s what you are trying to help solve. Providing insurance companies with cheaper reinsurance at the State level, admittedly backed by assessments on consumers if there is a shortfall, hasn’t really worked to lower rates.

Mr. MAHONEY. But why hasn’t it?

Mr. NUTTER. Our argument would be that, in fact, if you—why hasn’t it worked?

Mr. MAHONEY. Yes.

Mr. NUTTER. Risk assessment in the State of Florida, in terms of the exposure of the properties, is so great, and the probability of loss is so great, that the rates needed to adjust.

Maybe there is a sticker shock problem here with people in Florida. But at some point, the ultimate cost of repairing and replacing people’s homes and businesses has to be borne by someone, either those at risk or a subsidy by others, or government financial assistance.

Mr. MAHONEY. So you are basically agreeing that the size of the loss is so great, that current commercial market products are so

costly that it makes it unaffordable is what you're saying? You're agreeing with that statement.

Mr. NUTTER. I am not saying it's unaffordable for everyone. What I am saying—

Mr. MAHONEY. For a $42,500 a year family of four in a $125,000 home who are paying $8,000 a year in homeowners insurance is—somebody like that?

Mr. NUTTER. As I said earlier, there is no question that those at low incomes or fixed incomes, for whom there is an affordability problem at the consumer level, need to be addressed.

Mr. MAHONEY. Well, at the high end, Mr. Nutter, you know, all of my friends that don't have mortgages, you know what they're doing? They're just not buying insurance. So the wealthy have solved the problem by saying, "The cost is so high, that it's just cheaper for me to pay off my mortgage, and not to have insurance," right?

Now, the other problem a person with $42,500 has is that they have a fixed income, being a schoolteacher. But yet, when the rate goes up by the insurance company, guess what happens on their mortgage on a monthly basis?

So, again, the question I get back to is the fact that let's talk about the real problem. The real problem is that we can't get enough affordable insurance. And the CAT bond thing, I think, is interesting. I am hoping you're right, that people will be willing to lose their principal and get an 8 percent return. I'm skeptical. I think that's maybe one of the reasons why the market is so small.

But, certainly on the reinsurance side, the rates are so great, and the return is so great, it's great for the investor, but it does nothing for the person making $42,500 a year, and his $8,000 premium.

Mr. NUTTER. I don't think there is any question, Mr. Mahoney, that in looking at this legislation that you and Mr. Klein have proposed, that—it is not clear what the residual effect is going to be at the consumer level for what you have proposed. That's why more thought needs to be given to whether this proposal is sufficient to have value at that consumer level. There is no quid pro quo built in to the legislation about what States or insurance companies can or will do to help the consumer at the consumer level.

The State of South Carolina did something creative, by creating catastrophe reserve funds for consumers, so that they can build up—not unlike 401(k) or a medical savings account—funds for that. That's the kind of thing at the consumer level that perhaps would help.

Mr. MAHONEY. Yes, and I just hope you realize that I—everything we did with this bill was to try to make the private markets work. At the end of the day, we know one thing, that over 250 years, there is nothing wrong with the homeowners insurance marketplace. And what we have to do is we have to solve this timing event, and we have to solve the problem of unfunded liability. That's what is creating the instability.

And the problem is that the cost of your products are so great, and the liability is so great, that the average homeowner can't afford it. This bill solves that problem. Thank you.

Mr. KANJORSKI. Thank you. I ask unanimous consent that the New York Times magazine article, "In Nature's Casino," dated Au-

gust 26, 2007, highlighting some of the work Dr. John Seo, one of the witnesses here today, and a report published by the Georgetown University, titled, "Coastal Disaster Insurance in the Era of Global Warming: the Case for Relying on the Private Market," which Mr. Echeverria helped write, be submitted as part of the record. If there is no objection, so ordered.

Gentlemen, I want to thank you for participating in the second panel. I apologize that we held you over this late. As you picked up, our two erstwhile freshmen here did a yeoman's job in putting a bill together with a great attempt to solve a problem not only in Florida, but for most of the coastal United States.

And I daresay I think, as a result of this hearing, we have moved considerably further along that line to accomplish that end, with your assistance and aid. And thank you very much for your testimony.

With that, the Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses, and to place their responses in the record. This hearing is adjourned.

[Whereupon, at 6:21 p.m., the hearing was adjourned.]

A P P E N D I X

September 6, 2007

U.S. Congresswoman
Ginny Brown-Waite
Representing Citrus, Hernando, Lake, Levy, Marion, Pasco, Polk, and Sumter Counties

Joint Committees on Capital Markets and Housing Hearing
"H.R. 3355, the Homeowners Defense Act of 2007"
September 6, 2007
Statement for the Record

Thank you Mr. Chairman and Madam Chairwoman for holding this hearing today.

I also appreciate the witnesses appearing before the committee.

This hearing is long overdue for the residents of the Gulf Coast who have been abandoned in the property insurance crisis they're facing.

I have been working to bring relief to these residents for over three years, and I thank my colleagues from South Florida, Mr. Klein and Mahoney, in joining me in this fight.

I will be listening closely to learn how constituents in various areas of our great country are actually going to benefit from such the approach offered in H.R. 3355.

Also, I ask for unanimous consent that a statement from ProtectingAmerica.org be submitted for the record.

Again, thank you Mr. Chairman and I look forward to what our witnesses have to say today.

OPENING STATEMENT OF
CHAIRMAN PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

JOINT HEARING ON
H.R. 3355, THE HOMEOWNERS DEFENSE ACT OF 2007

THURSDAY, SEPTEMBER 6, 2007

We meet this afternoon to consider and review a bill introduced by our colleagues, Congressmen Klein and Mahoney of Florida. H.R. 3355 tackles a complex issue: how to address the growing problem of the availability and affordability of homeowner's insurance around the country and especially along our coastlines. I commend my colleagues for taking on such a difficult task. The Financial Services Committee and its predecessors have struggled with this topic for many years.

The costs associated with natural disasters continue to rise. According to the Government Accountability Office, insured losses associated with hurricanes alone have risen from $10 billion in the 1980s to $97 billion for this decade. Some attribute this increase to global warming. Others attribute it to the higher cost of real estate and increased density in high-risk areas. Still others attribute it to a climatic cycle where the frequency and intensity of storms is currently on an upswing that will eventually subside. Whatever the cause, the increase in costs is very real, especially for those who own homes in the areas most affected by natural disasters.

The central question before us today is therefore who should bear these costs. Should it be those who live there, the insurance industry, or the government? The answer could also be some combination of these parties as well as other sources.

My colleagues have carefully considered these matters in crafting their solution to the problem. In brief, their bill would provide States with an opportunity to plan ahead of time for covering the insured losses resulting from natural disasters, via our private markets. Their plan also offers emergency relief in the form of Federal loans for those States that may need access to funds after a major natural disaster.

Specifically, the consortium proposed in Title I of the bill would encourage States to cede risk to the capital markets. I look forward to learning more about the increased role our capital markets can serve in paying for the insured losses of natural disasters. We should, to the extent possible, maximize the risk-bearing capacity of the private sector before calling on the government to assist. Additionally, Title II of the bill creates a Federal loan program that would provide loans to any state facing a significant financial shortfall following a natural disaster if capital is not readily available by any other means.

The bill also aims to avoid the problems that have stalled previous efforts to mitigate the costs of catastrophic disasters for homeowners. States will voluntarily participate in the bill's programs, thereby hopefully avoiding cross subsidization from States that do not bear similar risks. Additionally, the bill aims to mitigate the transfer of risk to the Federal government. These important provisions ought to help the legislative prospects for the bill.

-more-

In sum, I look forward to hearing from our witnesses today on how H.R. 3355 may affect homeowners, businesses, insurers, reinsurers, investors, and all levels of government. I am also very interested in learning about any recommendations that experts may have about how to improve and refine the bill as the Committee continues to consider it.

TIM MAHONEY
16TH DISTRICT, FLORIDA

FINANCIAL SERVICES
AGRICULTURE

1541 LONGWORTH HOUSE OFFICE BUILDING
202-225-5792

Congress of the United States
House of Representatives
Washington, DC 20515–0916

Representative Tim Mahoney
Opening Statement
Hearing on "H.R. 3355, the Homeowners' Defense Act of 2007"
September 6, 2007

I would like to begin by thanking Chairman Frank, Chairman Kanjorksi, and Chairwoman Waters for their commitment to examining natural catastrophe insurance, and for having this hearing on H.R. 3355, the Homeowners Defense Act of 2007.

Before I begin summarizing the natural catastrophe insurance crisis affecting the 16th Congressional District of Florida, I want to reiterate that this is a national problem. Let me be clear. The Federal Government has been forced to act because private markets for homeowners insurance have failed. The issue ladies and gentlemen is not the industry's ability to pay claims, it is an American's ability to purchase affordable homeowners insurance. This legislation is essential as the investment in a home is the

single biggest investment an average American has and it is vital that we protect the American Dream of homeownership.

I am proud that this bill preserves the private homeowners insurance industry. It recognizes that no one got into business to underwrite a nuclear devastation be it man made or natural. This bill is voluntary as states can choose whether or not to participate. However, it sets a principal that no longer will the American taxpayer foot the cost of a natural disaster in an expensive bailout. We know that these catastrophic events will happen and this bill ensures that we plan for them in a manner that is cost effective and recognizes personal responsibility.

In 2004 and 2005, natural disasters resulted in approximately $89.0 billion in privately insured catastrophic losses. These disasters, and population growth in areas prone to natural disasters, have caused the insurance industry to adjust their models for insuring these events. As a result, insurers and reinsurers are pulling out of or are reducing their exposure in disaster prone areas of the

country. Today, the citizens of my state are the owners of the biggest homeowners insurance company with over 30 percent of the market!

In addition to the lost insurance capacity, homeowners have seen their premiums skyrocket. The toxic cocktail of rising gas prices, health care costs, and homeowners insurance has created a viscous cycle of terror for our seniors living on fixed incomes and our middle class families struggling to provide for their children.

Recently, I received a letter from one of my constituents detailing the difficult choices she had to make in order to pay her homeowners' insurance bill. Ms. Leanne Finnigan, a single mother of two, was dropped by her insurance company in 2006. She eventually found another insurance company, which charged her more than three times what she had been paying for similar coverage. As a result, she has been forced to work overtime on Saturdays, give away one of the family pets, and reduce her

weekly grocery budget. Unfortunately, Ms. Finnigan's story is not unique. Thousands of families across Florida have been forced to make similar difficult decisions.

Hurricane Katrina and the slow recovery efforts that followed have caused Congress and the nation to reexamine how to best handle the financial consequences of such large scale property damage. In fact, the Financial Services Committee has held numerous hearings this year on the issue. During these hearings, several facts became clear: the risk posed by natural catastrophes in not going away, the damage caused by disasters will keep growing, and insurance premiums have remained high, despite a calm 2006 storm season.

The Homeowners' Defense Act of 2007, which Congressman Ron Klein and I introduced, is a two-pronged approach designed to address the property insurance crisis. The bill is a national plan that is intended to allow private industry to operate at full capacity with support from the federal government. More importantly,

ensuring a stable insurance market will give the states impacted by severe natural catastrophes the ability to help their citizens rebuild their homes and their lives.

Title 2 of the bill, the National Homeowners Insurance Stabilization Program, extends low interest federal loans to states impacted by severe natural disasters. Specifically, the Program makes available two types of loans: liquidity loans and catastrophic loans. Liquidity loans will allow a state's catastrophe fund to cover its liability in the event that it is not fully funded at the time of a disaster. Catastrophic loans allow state catastrophe funds to cover damages that exceed its liability.

Because the legislation utilizes private capital markets and a loan program that requires repayment by affected states, it eliminates cross-subsidization. Taxpayers in Nebraska no longer have to bear the risk of those living in Florida.

This legislation is responsible, fair, and returns stability and competition to the private insurance market. I look forward to working with the Members of this Committee and key stakeholders to ensure that this legislation adequately accomplishes its intended goals.

Again, I would like to thank Chairman Frank, Chairwoman Waters, and Chairman Kanjorski for holding this hearing today, and I look forward to hearing the comments of our witnesses.

Statement of Congresswoman Carolyn B. Maloney
Financial Services Subcommittee on Housing
Legislative Hearing on H.R. 2930, Section 202, Supportive Housing for the Elderly Act of 2007
September 6, 2007
2128 RHOB
10:00am

I would like to thank Chairwoman Waters for holding this morning's legislative hearing on H.R. 2930, the Section 202, Supportive Housing for the Elderly Act.

I also congratulate Congressman Tim Mahoney for introducing this legislation.

Section 202 is the only HUD program that exclusively serves the elderly and is currently assisting over 320,000 housing units.

The bill under discussion today will reauthorize this program as well as make a series of improvement that will help expand the supply of affordable housing to the elderly.

Specifically this bill would:

- Help preserve the existing supply of affordable housing for seniors, while facilitating the development of new homes to meet increasing demand;

- Allow for adjustment to Project Rental Assistance contracts to accommodate fluctuations in project costs and emergencies, such as utility cost spikes;

- Maintain and upgrade existing Section 202 housing by allowing property owners to seek financing for the rehabilitation and improvement of current housing, while keeping costs low for their residents.

I think we can all agree that we must do all we can to allow our nation's seniors to retire with dignity.

With the rapid increases in housing prices over the last decade we have seen too many seniors priced out of the communities that they have help build.

The reauthorization of the Section 202 program will help provide more affordable housing options to seniors and afford opportunities for safe and affordable retirement.

Again, I thank the Chair and I look forward to the testimony of our witnesses.

Testimony of
John D. Echeverria
Executive Director, Georgetown Environmental Law & Policy Institute
Georgetown University Law Center

Hearing on H.R. 3355, the Homeowners Defense Act of 2007

Before
the Subcommittee on Housing and Community Opportunity and
and the Subcommittee on Capital Markets
Committee on Financial Services

September 6, 2007

My name is John D. Echeverria and I am the Executive Director of the Georgetown Environmental Law & Policy Institute at Georgetown University Law Center. I appreciate the opportunity to testify today on H.R. 3355, the Homeowners Defense Act of 2007, and to address, more generally, the appropriate role of the federal government in supporting the availability of fairly priced coastal disaster insurance. The views I offer today are my own, and do not represent the position of Georgetown University, Georgetown University Law Center, or the board of the Georgetown Environmental Law & Policy Institute.

The Georgetown Environmental Law & Policy Institute recently published a report on this topic authored by Justin R. Pidot, a Fellow with the Institute during the 2006-2007 academic year. I understand that a copy of the report, *Coastal Disaster Insurance in the Era of Global Warming, The Case for Relying on the Private Market*, will be included in the hearing record. The report is also available at: http://www.law.georgetown.edu/gelpi/CoastalDisasterInsuranceReport.pdf.

At the outset, I should acknowledge that I am not an expert in insurance law nor in the operations of the insurance industry, the reinsurance business, or the broader capital markets. However, I have spent a great many years studying, in various contexts, the effects of different liability and incentive regimes on the behavior of governments and private entities. Also as reflected by our recent report, the Institute has devoted significant resources and energy over the last year to studying the implications of different potential government polices relating to coastal disaster insurance.

In approaching the issue of coastal disaster insurance, our analysis has been driven by two basic policy concerns: fairness and efficiency. In this context, the fairness concern is that citizens and communities should generally bear the costs associated with their decisions and that other citizens and communities should not be asked to subsidize these costs. The efficiency concern is that society as a whole will be better off if citizens and communities make decisions that take full account of the private and public costs of their choices. The fairness and efficiency concerns are related in the sense that, everything else being equal, avoiding unfair subsidies is likely to increase the ability of individuals and communities to make rational, fully-informed decisions that will enhance the general welfare. More specifically, in the context of coastal disaster insurance, we as a society are more likely to achieve the right level of risk avoidance and risk mitigation if citizens make decisions about what to develop and where to develop based on the actual costs associated with their choices.

We have concluded that, for several different reasons, a significant government intrusion in the market for coastal disaster insurance is not likely to serve the goals of fairness and efficiency. For understandable but nonetheless regrettable reasons, government, especially the federal government, can generally be expected to do a poor job of supporting coastal disaster insurance that is priced to reflect its true cost. The financial burdens imposed by disasters, and/or the premiums necessary to cover such losses, create a strong, concentrated, and highly motivated constituency seeking financial

relief from these burdens. On the other hand, the costs to the federal government and in turn to federal taxpayers of providing this relief are dispersed and often deferred to the future. As a result of this political dynamic, there is a substantial risk, verging on an inevitability, that federal government involvement in the disaster insurance market will lead to systematic under-pricing of coastal disaster insurance. Furthermore, the costs to the federal taxpayers of federal intervention in the disaster insurance market are likely to increase over time.

Under our federal system, responsibility for addressing coastal disaster hazards is generally divided between different levels of government. Traditionally, local governments, and to a lesser extent state governments, exercise primary regulatory authority over land development. On the other hand, disaster relief is generally regarded as a responsibility of the federal government; in line with this approach, H.R. 3355 would require the federal government to serve as a financial backstop for state insurance programs. If land use regulatory authority remains at the state and local levels but the federal government serves as a financial backstop, the level of government with the most to gain from development (through increased tax revenues, and general economic development) will bear relatively little financial exposure from potentially unwise development, whereas the level of government with the greatest financial exposure will have little direct authority to limit and mitigate the risks associated with unwise development. This misalignment of incentives will tend to encourage unwise coastal development, create greater long-term risks, and ultimately impose greater costs on federal taxpayers.

We can predict these outcomes with a fair degree of confidence based on the unfortunate history of the National Flood Insurance Program, under which the federal government already plays a major role in providing insurance coverage for flood damage associated with coastal disasters. This program, established in 1968, was originally designed to guarantee the availability of flood insurance while simultaneously promoting new controls to limit vulnerable development in flood-prone areas. Unfortunately, the program now provides a major subsidy, not only for pre-existing development but also for new development in floodplains, with the result that the program has actually become a major engine for unwise development in floodplains. In some cases property owners have received multiple payments because their properties flooded time and again, despite the fact that, in the absence of the federal program, no rational individual would rebuild and no rational private insurer would offer coverage in the floodplain. In addition, the majority of NFIP flood maps are out-of-date, with the result that many maps fail to identify properties that are within the 100-year flood plain and should be covered by insurance. Finally, as we discuss in our report, because the federal government bears the lion's share of the financial risks associated with unwise development, local governments sometimes act recklessly by encouraging floodplain development.

The concern that political pressures would lead the federal government to adopt policies leading to under-pricing of disaster insurance becomes even more serious when one considers the fact that environmental factors are likely to put significant upward pressure on insurance rates. The growing scientific consensus about global warming

suggests that sea levels will rise significantly over the next century, making more coastal areas vulnerable to storm damage. In addition, because of the commencement of a natural cycle of heavy hurricane intensity, and perhaps due to global warming, hurricanes apparently are becoming more intense. As coastal areas become more prone to storm damage, common sense suggests that, absent government interference, insurance rates would rise in order to cover the larger risks. Higher rates would also have the salutary effect of sending property owners and investors valuable price signals about the hazards they face. On the other hand, if insurance rates were constrained for political reasons, insurance rates both would become increasingly divorced from fair rates as determined by the character of the underlying risks and would not effectively inform owners and investors about the risks they face.

All of the likely negative consequences of federal government intervention in the insurance business, as serious as they appear to be, might be acceptable if a government backstop were the only alternative. But our review of the available evidence indicates, at a minimum, that the proponents of federal intervention have not made the case that private reinsurance and innovative capital instruments cannot serve this backstop function as well or better than the U.S. Treasury.

By way of background, it is noteworthy that a federal takeover of the flood insurance business was hardly the only possible option. In the early part of the last century, after a series of disastrous Mississippi River floods, Congress began to debate the need for federal flood insurance. On the theory that the risks involved were too unpredictable and/or beyond the capacity of private insurers to deal with, Congress eventually created the National Flood Insurance Program. But other nations have left the business of flood insurance largely if not entirely to private insurers. It is fair to ask whether our nation's overall vulnerability to flood risks would be lower today if Congress had never created the flood insurance program and left the business of flood insurance to private insurers.

Recent developments in the insurance industry suggest that the private sector can succeed in providing insurance to citizens and businesses in hazardous coastal areas at a fair price that reflects the true costs of the covered risks. While hurricanes and other coastal storms are not an every day event, the occurrence of coastal storms and the magnitude of the potential economic losses are reasonably predictable. There is now a small but rapidly growing business in generating detailed predictions about where storms will occur and with what impact, as described in Michael Lewis's article in the August 26, 2007, New York Times Sunday Magazine. These predictive data are in turn providing the information base necessary to support capital investments in insuring against coastal disasters. There is now reportedly a $14 billion market in investments in disaster insurance and the market continues to grow.

So far as we have been able to determine through our research, there is no serious obstacle to reinsurers and private investors supplying the necessary backstop for a well functioning coastal disaster insurance business. Given the size of the worldwide capital markets, and the likely magnitude of future disasters, the capital market appears adequate

in size to absorb the inevitable year to year swings in the number of disasters. Over time, as the predictive data improve in quality, and investors gain experience in pricing these instruments, the prices of these instruments should stabilize at a level that fairly and accurately reflects the underlying risks. The participation of numerous investors in this market, each with a relatively small stake in the overall risk pool, should, again over time, reduce if not eliminate the premiums that investors apparently now demand based on the unpredictability of coastal disasters (the so-called "timing problem").

Thus, the most serious obstacle to the eventual emergence of a private market solution to the current so-called insurance crisis appears to be potential federal legislation that would allow the federal government to effectively supplant the private sector and cause the private market in disaster insurance instruments to shrink and wither away.

In sum, the best federal government policy with regard to coastal disaster insurance appears to be a policy of doing as little as possible. On the one hand, there is a substantial danger that federal intervention would lead to unfair and inefficiently low insurance rates for coastal disasters. On the other hand, there is no apparent reason why, over time, the private insurance companies and investors cannot support a well-functioning insurance business in which insurance premiums reflect the true market price of the coverage. No doubt there are risks of dramatic swings in the private marketplace based on the emergence of new information and irrational market sentiments. But, on balance, the risk to the taxpayer and to the country's general economic welfare appears significantly lower if, to the extent possible, the business of investment is left to insurance companies and to private investors.

This is not to suggest that there is no role for the federal government (and state governments) in the insurance market for coastal disaster insurance. As detailed in the recent Institute report, there appear to be at least several targeted reforms worth considering. First, the federal government could play a useful role in generating better maps and other data that would allow insurance companies and other private firms to do a better job of estimating the magnitude of the risks associated with different areas of the coast as well as with specific properties. These data would allow insurance companies to do a better job of fine tuning insurance rates to reflect the risks associated with individual properties and avoid generalized premium structures that ignore differences between properties. In addition, these data would be of assistance to Applied Insurance Research and similar companies that develop risk assessments of coastal hazards. While the NFIP has done a woefully poor job of keeping flood maps current, the existence of a growing private sector audience for coastal hazard information offers hope that the federal government might develop a stronger information dissemination capability in the future.

Second, Congress should consider amending the Internal Revenue Code to eliminate taxation of insurance premiums that companies devote to reserve funds to cover catastrophic loses. Under current law, private insurers pay ordinary taxes on any portion of the premium they set aside as a reserve against future losses, leaving companies with little incentive to set aside adequate funds to cover catastrophic losses. Allowing insurance companies to "bank" premiums to cover future catastrophes would allow

companies to treat disaster insurance like other, more predictable lines of coverage, and expand companies' capacity to offer hurricane insurance. If it were to pursue this option, Congress would need to take care to ensure that banked premiums are eventually used to pay disaster insurance claims and not simply accumulated as an untaxed corporate asset.

Third, Congress should consider providing targeted financial assistance to low and moderate income families that have been particularly hard hit by spikes in coastal insurance rates. This assistance should be limited to those who purchased their properties at least several years ago and who can fairly claim that they purchased their properties without full knowledge of the hazards involved. To avoid distorting the insurance market and creating so-called "moral hazard" problems, this relief should not be supplied in the form of lower insurance rates, but rather in the form of direct grants or, as recently suggested by one of the co-directors of the Wharton School's Risk Management and Decision Processes Center, through some type of voucher system.

At the state level, state governments should consider making wind insurance mandatory for all those in vulnerable areas of the coast. Automobile liability insurance is mandatory in most states, and Massachusetts now requires all residents to carry health insurance. Given the infrequency of coastal disasters, citizens tend to discount the nature of the risk they face and therefore tend to underinsure. Mandatory coastal disaster insurance would overcome this psychological effect, enhance every community's ability to deal with a disaster, and compel citizens to recognize and take into account the different level of hazard associated with building and owning property in different areas.

Finally, I offer the following brief comments on H.R. 3355, the Homeowners Defense Act of 2007. First, the bill does not appear to advance the goals of fairness and efficiency I outlined at the beginning of my testimony. Through the liquidity and catastrophic loan programs, the bill would make the federal government the financial backstop for states (with or without "qualified" state reinsurance programs) by requiring the Secretary of the Treasury to make loans to states at predetermined interest rates. There is no indication that these interest rates are intended to match the market price of providing insurance for the covered risks. In fact, the proposed rates appear significantly lower than those now being earned in the capital markets by cat-bonds. The bill also includes a broad provision for extending the term of any loan upon state request. The predictable effect of these provisions would be to extend an unfair taxpayer-funded subsidy to those who choose to live and work in hazardous coastal areas, encourage further development in hazard-prone areas, and stifle the development of a private market backstop for coastal disaster insurance.

One striking feature of the bill is the complete absence of any explicit requirement that local or state governments take specific steps to control and mitigate disaster risks as a condition for eligibility for the federal backstop. The effectiveness of such mandates is questionable, based on experience under the National Flood Insurance Program. Nonetheless, it would seem appropriate, at a minimum, to consider mandating risk mitigation and control in order to decrease, at least to some degree, the incentives these federal loan programs would otherwise provide for unwise coastal development.

The purpose and likely effect of creating the proposed consortium is unclear. As I have discussed, there is a role for the federal government in generating additional hazard data information and disseminating that information to private insurers and risk assessment firms, and the consortium might help serve that function. But it appears doubtful that states facing relatively low levels of risk would perceive any particular advantage in banding together with states facing higher risk levels in order to seek pooled investments to help cover coastal disaster risks. In addition, from the point of view of reinsurers and private investors, it appears questionable whether there would be any particular advantage in a quasi-federal entity attempting to pool risks in a way that the market might or might not find attractive. As we describe in our report, private insurers are already independently putting together packages of different types of risks in order to attract more outside investors. Finally, to the extent the existence of the consortium would create the misperception that the federal government is prepared to backstop state insurance programs, the mere creation of the consortium would likely skew insurance premiums and encourage unwise development.

* * *

Thank you for the opportunity to testify and I would be happy to respond to any questions that members of the Committee may have.

Remarks on September 6, 2007 by The Honorable Thomas B. Evans, Jr. before the sub-committee on Housing and Community Opportunity and the sub-committee on Capital Markets regarding H.R. 3355, The Homeowners Defense Act of 2007.

Thank you very much for your invitation to testify today. Many years ago I served on this Committee and I have appeared before other Congressional Committees but this is a first for me in testifying before the Financial Services Committee and I am pleased to be here.

The older I get the more I'm concerned about the future. I believe that the policies we establish today must not just consider the quick fixes but must address the longer term and their impact on future generations. I'm very concerned about many issues but one that is especially troubling is the amount of money spent by the Federal Government. I remember so well my vote on raising the debt ceiling limit to one trillion dollars. (I believe that was in1980). In the last six years alone, the debt ceiling has risen by 1 ½ trillion. Fiscal policy has far reaching consequences and most importantly it affects our Nation's security because of its impact on our economy. We are awash in debt and consequently the days of throwing taxpayer dollars at a problem without thoroughly assessing the consequences should be over.

That brings us to today's hearing on H.R. 3355. On the surface, especially if you live in Florida, Congressman Klein and Congressman Mahoney's bill sounds good. However, in my view, before there is a rush to judgment in passing their legislation it should be examined very closely and one hearing like the one today, respectfully, is not sufficient.

As I understand it, H.R. 3355 creates a consortium of States that join together to protect against unexpected catastrophic losses. A National Fund is set up and that fund provides liquidity for State catastrophe funds.

Let me share with you some recent experience I have had working with a development project that could have ended in a catastrophe. As some of you may know, the Florida Coalition for Preservation, which I chair, was established about 5 months ago to promote responsible development in storm prone areas and to preserve barrier islands. Our mission was to educate policymakers at every level and to also educate the public. Some large developers secured an option to buy the tiny town of Briny Breezes, all 43 acres of it, for $510,000,000.

Briny was and is a classic Barrier Island in South Florida situated between the Inter-coastal and the Atlantic Ocean. The only way the developers could make their project economically viable was to go up, way up with hi-rises. The density created by their projected development quadrupled the population of the area and doubled the traffic on A-1-A. Clearly, this type of development would dangerously stress the surrounding infrastructure. It would have been totally incompatible with the surrounding communities. Fortunately, the State of Florida told the developers that their plan was unacceptable. It would have placed too many people in harm's way in the event of a catastrophic storm.

It was a reasonable decision but nothing compelled the State to find the comprehensive plan presented by the developers unacceptable. Most of the standards used in Florida's Growth Management Act are subjective. They are not codified in law.

The National Catastrophe Fund envisioned by the legislation you are considering today does not address the responsibility of States to reduce risks and mitigate losses that will occur in the event of a

catastrophic storm. We certainly cannot anticipate what Mother Nature will do but we <u>can</u> and <u>should</u> take steps to reduce risks and lessen damages. "An ounce of prevention is still worth a pound of cure."

I hope you will include in the legislation you are considering a requirement that States demonstrate that they are taking initiatives that will reduce risks and mitigate damages to the maximum degree practicable. Tough building codes, for example, and very importantly some standards that prevent intense development on vulnerable storm prone barrier islands.

The Florida Legislature, for example, could pass amendments to the Growth Management Act that would reduce risks. Arguably, this approach could save lives, some fragile land, and huge amounts of taxpayer paid for subsidies. I might add that it could also reduce the premiums paid for insurance. This would be tangible recognition that the States understand that in accepting assistance they must bear their fair share of the responsibility. We should discourage rather than encourage unreasonable risk taking.

I sincerely hope that the distinguished members of the Financial Services Committee will carefully address these concerns.

**TESTIMONY OF ROBERT JOYCE
ON BEHALF OF
THE PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES
AND THE
SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES**

SEPTEMBER 6, 2007

My name is Robert Joyce and I am Chairman and CEO of Westfield Group. Our insurance group writes personal and commercial insurance in the Midwest and South Atlantic regions of the U.S. We insure homes, autos, farms and businesses writing just over $1.5 billion in premiums in 2006. I am also vice chairman of the Property Casualty Insurers Association of America (PCI). PCI is a trade association representing over 1,000 property/casualty insurers that write almost 40 percent of the homeowners insurance sold in the United States. PCI and Westfield have a significant interest in ways in which we can better prepare our industry and our nation to respond to natural disasters. Thank you, Chairs Kanjorski and Waters and Ranking Members Pryce and Biggert for providing me with the opportunity to appear before you today. Please know that PCI is committed to working with the committee to find ways to reduce the risk of significant loss to homeowners.

Introduction

PCI testified before the Subcommittee on Housing and Community Opportunity in June and September of 2006 and March 2007 concerning natural disaster issues. We are pleased to be invited here today to discuss H.R. 3355. Developing effective public policy for natural catastrophes is one of the most significant issues facing the nation and the insurance industry today. Experts agree that America faces the likelihood of more frequent and severe natural disasters in the coming decade. Moreover, significant property development, population growth, and rising real estate prices in areas prone to natural disasters exacerbate the potential for larger human and economic losses. These facts require stronger loss prevention and mitigation and greater financial resources for recovery.

Peter L. Bertstein, a Wall Street investment manager and consultant, in his book; *Against the Gods*, discusses the importance of measuring risk, from both a financial and survival standpoint. In order to manage risk, one must consider the consequences of risk. This is a fact for insurers as well as businesses and individuals. We must all do a better job of managing our risk. For this reason, when it comes to insuring against the financial devastation caused by natural disasters, all of us share the same goals. We want to reduce the losses from catastrophes by making homes stronger and people safer. We want to limit development in the highest risk areas through effective land use management. And we want to make insurance more affordable and available by combining private market

competition with appropriate governmental participation to assure that we have the financial strength to weather any storm.

PCI believes there may be a property structured role for the federal government to play in assisting the financing of mega-catastrophe risk and we believe it should be given serious consideration by Congress now - before the next crisis. We commend you and your colleagues for your attention to and leadership on this issue and for your continued efforts to find innovative solutions to the problem of catastrophe risk such as H.R. 3355. This bill contains a key provision that PCI has been advocating for more than a year; a "liquidity loan" program for State or regional catastrophe funds.

Many other ideas such as federal reinsurance, expansion of the National Flood Insurance Program (NFIP) to include windstorm and flood coverage, flood insurance program reform, a study commission, tax-favored individual and/or insurer accounts to allow for the accumulation of funds to pay for catastrophic events, etc. have been put forth since the 110th Congress has convened. While PCI believes that some of these ideas should be considered and carefully debated further, we believe that the "liquidity loan" program provision in Title II of H.R. 3355 should be one of the key elements of a comprehensive public-private program to address catastrophe issues. The goal of our industry and, we believe, any federal response is to make sure that following a major catastrophe, our policyholders and the citizens of this country can rebuild and get their lives back on track as soon as possible. Accordingly, a public-private partnership that provides financial stability to the industry, the states, and allows insurers to do their job following a major event is essential.

Comments on the Catastrophe Problem

PCI members play a pivotal role in protecting American homeowners and supporting our nation's housing markets by providing the products and services needed to protect homeowners, lenders, businesses, and communities against exposure to natural catastrophes. Our members are proud of the work they do in these markets.

In 2004 and 2005, property insurance markets have been tested as never before. Catastrophe losses in 2005 totaled some $61.9 billion, nearly doubling the previous record losses in 2001. Hurricane Katrina itself caused nearly $40 billion in insured losses, surpassing the roughly $32 billion from 9/11. The vast majority of claims from 2005's events have been paid and the insurance market has met its financial obligations. In PCI's view, the most important catastrophe issue facing us today is whether the market has, or is building, the capacity to pay for catastrophes the nation will face in the future.

Given the very serious catastrophe losses we've seen over the past several years and the significance of this issue for our membership, our organization has devoted considerable time and effort to develop sound public policy solutions that we can recommend.

There are several fundamental issues that have to be addressed:

- First, America clearly faces the prospect of increased frequency and severity of major hurricanes and the continuing threat of other major natural catastrophes including earthquakes, floods, tsunamis, and volcanic eruptions. Weather modelers tell us that we are in a prolonged period of increased severe storm activity. Seven of the ten most costly natural disasters in U.S. history have occurred since 2004. We can't afford to ignore this reality.

- Second, America is experiencing significant development, population growth, and rapidly rising real estate prices in areas that are highly prone to natural disasters. AIR Worldwide, one of the leading risk modelers in this country, states that there is currently some $7 trillion in property values exposed to catastrophe risk along America's coastlines; some $3 trillion of it is personal property. Even if storms were no more frequent or severe than in the past, this fact alone means that future storms will be more damaging and more costly to insure. As a result of migration and property development, the nation faces growing exposure to significant catastrophe losses and increasing costs of recovery. "Baby-boomers" have moved to warmer climates and coastal areas so that now, more than 54 percent of the U.S. population lives within 50 miles of a coast.

- A growing number of Americans have a significant portion of their net worth exposed to catastrophic loss. The impact of major natural catastrophes on the economy will be larger and will likely lead to significant public policy debates over how best to address this risk.

- As an insurer, Westfield Insurance and other PCI members would prefer to rely on free global market forces to solve this problem whenever possible, with prices and products tailored to match the risks freely assumed. We think that such an approach would, over time, establish appropriate economic incentives for those who live and work in catastrophe-prone areas and would attract badly-needed private capital for risk protection. However, we must also recognize that our industry does not operate in an unregulated market. Our members work in a world where prices and coverage terms are highly regulated and generally are not allowed to respond freely and in an immediate fashion to changing risks or conditions.

  We also recognize, as we must, that people do not simply pick up and move from one place to the next, irrespective of their homes, families, and community ties. Any set of realistic policy options must take this into account.

- Finally, with respect to preventing and reducing losses, states frequently have outdated and inconsistent requirements for building codes, code enforcement, and other prevention/mitigation tools in areas dangerously exposed to disasters. These weaknesses imperil lives, property, and policyholder resources.

We agree with Congress that this is a major public policy issue that must be addressed; we believe the problems posed by catastrophe risk are growing more severe; and that a range of potential solutions must be considered, including market reforms, stronger loss

prevention, and new approaches to financing catastrophe risk. We do not believe there is one "silver bullet" to solve this problem, but rather a full range of changes that will have to be made.

Policy Options to Consider

As we look at the issue, PCI suggests four major areas for consideration.

Reduce Exposure to Catastrophe Losses

First, we need to do more to control and reduce catastrophe exposure. PCI suggests the following:

- We believe state and local governments must take seriously the need to restrict development in catastrophe-prone areas. This is not only an issue for single family homes. Ongoing commercial development on our nation's barrier islands or in the wetland marsh areas also significantly increases these risks.

- State and local governments should urgently and immediately review their building codes in catastrophe-prone areas. Wherever needed, they should upgrade their codes. Stronger building codes protect lives and significantly reduce property damage and repair costs. In a highly competitive insurance market, those savings will be passed directly back to consumers. Some have argued that it costs too much to rebuild to meet modern building code standards. Louisiana State University's Hurricane Center has estimated that the marginal cost of building a structure to meet higher wind-borne debris requirements in the International Residential Code is between 1.5 and 4.5 percent of additional cost. On a single-family home with a $100,000 mortgage, that works out to about $27 extra dollars per month. We think such investments are vital.

  PCI supported passage of minimum building code legislation in Louisiana and Mississippi in 2006, as well as an unsuccessful effort to extend stronger building codes into the Florida panhandle. However, the Florida legislature realized that this delay in applying its strong statewide building code in the panhandle was inappropriate and in its 2007 special legislative session on insurance, eliminated this exception. Finally, as much as we supported and are proud of our work to enact stronger codes in Louisiana and Mississippi, we know that much work needs to be done to implement and enforce these new standards, including making sure there is enough funding for the training of building inspectors.

- A second idea is the establishment by the federal government of incentives for greater investment in loss reduction and prevention. We suggest consideration of several ideas. First, the insurance industry's Building Code Coalition has recommended that enhanced disaster mitigation grants under the Stafford Act be provided for states that adopt stronger statewide building codes. This would address the funding issue mentioned above and PCI strongly endorses this approach and urge Congress to enact legislation for this purpose. Roughly one

dollar spent to better protect a property results in four dollars saved following an event. Clearly, one of the major limitations of any new building code enactment is the fact that it typically can't address improvements needed in the existing housing stock. This approach gives homeowners themselves additional incentives to make these improvements.

- We believe greater steps can be taken for preparedness and PCI has completed and distributed to forty-eight state insurance departments a PCI Regulators' Kit, containing recommendations for disaster preparation and response. This kit contains model regulations covering five critical areas, including: establishing an Insurance Emergency Operations Center; disaster claim reporting requirements; cancellation and non-renewal of insurance under disaster conditions; suspension of premium payments under disaster conditions; and mediation of disputed claims. When adopted, these regulations could improve the necessary coordination and communication after a catastrophe and help those whose lives and property are at stake.

Fix the Flood Program

Second, we believe Congress should complete its efforts to reform the NFIP. PCI strongly endorsed reform efforts last year and we continue to do so. The NFIP is a necessary policy response and must be continued. However, the program needs numerous reforms, the majority of which are contained in the Flood Insurance Reform Act of 2007 as introduced (H.R. 1620); but not as passed by the House Financial Services Committee in late July (H.R. 3121). The inclusion in H.R. 3121 of provisions that would expand the NFIP to include providing coverage for windstorm and flood losses is not something that PCI supports. We continue to believe that making a major change such as this to a program that is in need of other significant reforms in order to address current issues is unwarranted. We support efforts to pass a flood insurance reform bill this year, without the "multiple-peril" provision and we are willing to work with you to accomplish this goal.

Expand Private Sector Capacity

Third, a key part of the long-term solution to natural catastrophe exposure is to expand private sector capacity to handle the risk. PCI strongly supports efforts to make markets more responsive to the risks we face. Prices and terms of coverage that are openly and freely established in competitive markets can create essential incentives for property owners and attract new capital to these markets. As you know, homeowners insurance markets are heavily regulated in virtually all aspects of their operations. We face significant regulatory constraints, particularly in rating, but also in other areas, that inhibit effective market responses and discourage capital from entering these markets. We believe that the markets will need to transition to address availability issues. There are several things we think policymakers at various levels of government can do to address this problem:

- Insurance markets need greater freedom to respond to the exposures we face. In free markets, prices and terms of coverage tell consumers the true cost of insuring against catastrophes and are an efficient means of funding exposures. Regulators often fear that giving up regulatory control will make the problem worse and invite consumer backlash. However, based on the experience we've seen in states that have taken this approach, including South Carolina and New Jersey most recently, we believe the results would be just the opposite. Free markets encourage new capital to enter where insurance protection is needed and develop more capacity, not less. PCI will support state legislative initiatives intended to remove regulatory barriers to free markets for catastrophe insurance and will oppose enactment of new barriers.

We also encourage your review of two additional proposals:

- We are very interested in, and in fact endorse, establishing voluntary, tax-deferred insurance company catastrophe reserves such as H.R. 164 introduced by Rep. Jindal. H.R. 164 contains provisions that PCI believes should be modified, and as such, we have provided some members of these committees with draft wording and, in fact, have drafted legislation that we believe addresses these issues and would be happy to work with the author to modify H.R. 164 or with any member of these committees to have our version of this legislation introduced, debated and, hopefully, passed by Congress.

- We believe that there may be specific steps that could be taken to remove regulatory, legal, accounting, or tax barriers to further growth in the catastrophe bond market. This market provides another outlet for catastrophe risk financing and introduces new sources of capital and competition. A report earlier this year from Guy Carpenter described the growing importance of this market for financing catastrophe risk. While we certainly don't see the cat bond market displacing traditional reinsurance, market participants tell us that bringing more of these offerings "onshore" and reducing a variety of regulatory barriers will permit the market to grow. In principle, PCI strongly supports steps that will attract more private capital to address catastrophe risk and we are very interested in how this might be done in the catastrophe bond market.

Title I of H.R. 3355 establishes a federal "consortium" that addresses the goal of bringing new capital into the marketplace. As drafted, this consortium would be a "centralized repository" for all the information related to catastrophe risks and would have the ability to "issue securities and other financial instruments" and enter into "reinsurance contracts with private parties". We understand from speaking with the bill sponsors' staff that the Consortium envisioned will in no way provide a tax advantage and should explicitly not compete with or crowd out the private marketplace. PCI hopes that the Committee will clarify the bill language during markup of H.R. 3355 on this point and is encouraged to see such a forward-thinking idea included in the legislation. We look forward to working with you to modify these provisions so that capital market solutions such as catastrophe bonds can be more easily established and be less expensive.

State and Federal Government Involvement

Finally, with regard to state and federal government involvement:

- Based on our review of this issue, we believe the growth in natural catastrophe exposures is of sufficient magnitude in some states that it may require consideration of state natural catastrophe funding facilities. The events of 2004 and 2005 show that the insurance industry can respond to very severe catastrophe events. However, private markets may not always have the capacity to fund increasingly more frequent exposure to "mega catastrophes" or to a series of very large events in a single season. Given the magnitude of risk in certain states, our approach will be to look at specific conditions in each state to determine whether a catastrophe fund, or other financing mechanism, might be helpful.

  When we consider whether a state needs a catastrophe fund, we look also to see: (1) whether private markets have pricing and underwriting freedom to respond to market conditions; (2) whether care has been taken to prevent a catastrophe fund from damaging stable private markets or preventing new capital from entering the market; and (3) that the funding of the state program doesn't rely on cross-subsidies across lines of business. By their nature, cross-subsidies damage the ability of markets to provide strong price signals and incentives for behavior. Having said that, we believe there may be cases and states where a catastrophe fund can be part of a well-rounded solution and must be considered.

- Second, we would suggest that there may be some mega-catastrophe exposures that are beyond the capacity of the private market and even of an individual state catastrophe fund. In these times, following "mega catastrophes", it may be necessary for the federal government to offer liquidity protection to state catastrophe funds to stabilize markets and avoid widespread insurer insolvencies. Federal involvement may also be essential if the nation suffers repeated large events within a short time period. Lest anyone thinks that scenario is impossible, we would remind you of how close Hurricane Rita came to hitting Houston last year, only a few weeks after Katrina devastated New Orleans and the Mississippi coast. It is not inconceivable that several of our major cities could be struck by Category 4 or 5 storms within a single season, or that a major earthquake could strike in the same year as a significant hurricane.

H.R. 3355, Title II, Section 202 contains provisions for "liquidity loans". We are pleased to see the "liquidity loan" idea incorporated into H.R. 3355. Such a facility would offer credit financing to state catastrophe funds, intended to provide access to cash to meet immediate claim requirements following a qualifying event or events. However, we are mindful of the need to be extremely careful in structuring any federal role and of the overriding need to attract new private capital to the market. Accordingly, any federal financing role should include measures intended to promote freedom for markets to respond to these exposures, including support for greater rating freedom, support for actuarial soundness of private market rates, freedom for product innovations, use of sound underwriting tools, and lower market barriers. While the "liquidity loans" are

provided for a "qualified reinsurance program" in Section 202 of the bill, there do not appear to be any requirements that would promote market freedoms, as the term is defined in Title III, Section 301. The point of connecting standards for market freedoms to the creation of a federal financing facility is to provide incentives for the states themselves to do everything they can to attract private capital before asking for federal assistance.

Title II of H.R. 3355 includes a provision that allows for these liquidity loans to be made once the insured losses are "in excess of 150 percent" of the area's "aggregate direct written premium for homeowners insurance" for the previous calendar year preceding the event. PCI believes that the threshold for liquidity loans is too low and would negatively impact the private market. A task force of PCI members thoroughly analyzed the trigger level issue and we would like to share some the results of their work with you.
PCI believes that it is extremely important to develop trigger levels based on actual historical events evaluated in today's dollars. The PCI Task Force began with the belief that the threshold to qualify for federal liquidity financing should be a one-in-75-year event. This is an event that has a one-percent chance of occurring every 75 years. We felt that this was a justifiable benchmark because it is approximately \$80B of insured loss, which is also approximately the sum of insured losses of the 2004 + 2005 storm seasons. It is a repeat of the 1926 Category 4 storm that hit Miami, adjusted to 2006 costs. We also measured this threshold using a major earthquake in California which would result in approximately \$89B of insured loss, essentially a repeat of the 1906 San Francisco earthquake.

We took into account the fact that in many cases hurricane damage seems limited to only one state. We recognized this and understood that something was needed for the single state event that would be devastating to that particular state, yet may not reach the one-in-75-year benchmark. As such, we determined that an alternative benchmark of five percent of a state's gross product would be a fair and easily quantifiable threshold to qualify for financing from the federal liquidity facility, especially for smaller states.

Using the five percent trigger, the Florida Hurricane Catastrophe Fund might qualify fairly readily in a bad – but not extreme – year. Five percent of that state's gross product in 2005 dollars is \$34B. It should be noted that, in 2005 dollars, Hurricane Camille caused a loss equal to 14 percent of Mississippi's gross product and that Hurricane Hugo caused loss equal to seven percent of South Carolina's gross product. Under H.R. 3355's provisions, Florida would be able to access the "liquidity loans" following an event that caused insured losses of just over \$10 billion. The state and private markets in Florida have the ability to respond to such events.

Section 202 provides for "catastrophic loans" to state or regional catastrophe funds, under certain circumstances that are not "qualified reinsurance" plans or to "state residual market" entities. PCI understands that this would provide a mechanism for states without existing "qualified reinsurance" programs to access federal funds to pay claims using the same threshold for losses as with the "liquidity loan" program. PCI believes that making these "catastrophic loans" available to these entities would impede private markets and would send the wrong signals to states that have created programs to cover losses from catastrophe risks. These types of loans appear to allow states to benefit from a federal

loan program without taking the necessary steps to do everything possible to allow market freedoms, reduce or prevent losses and allow risk-based premiums before seeking federal assistance. Also, for the reasons stated above, we believe that these thresholds are too low. The provisions of this legislation also do not specify where funds to pay back these "catastrophic loans" would come from, leaving it up to the states and the entities borrowing these funds to make that determination. PCI is concerned that the costs of these loans could simply be passed on to insurers without the ability of insurers to recoup these costs from policyholders through specific premium adjustments or surcharges. Following such actions, policyholders in these states could be faced with insurer insolvencies, further adding to the problems following a catastrophic event. Therefore, PCI recommends that the "catastrophic loan" provisions be redesigned or substantially modified.

Conclusion

On behalf of PCI and its members, thank you for the opportunity to appear here today. PCI and its members look forward to working with you on H.R. 3355 to address these very important issues.

NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®

500 New Jersey Avenue, N.W.
Washington, DC 20001-2020
202.383.1194 Fax 202.383.7580
www.realtors.org/governmentaffairs

Pat Vredevoogd Combs
ABR, CRS, GRI, PMN
President

Dale A. Stinton
CAE, CPA, CMA, RCE
EVP/CEO

GOVERNMENT AFFAIRS
Jerry Giovaniello, Senior Vice President
Walter J. Witek, Jr., Vice President
Gary Weaver, Vice President

STATEMENT OF
VINCE MALTA ON BEHALF OF
THE NATIONAL ASSOCIATION OF REALTORS®

Before a joint hearing of

The Subcommittee on Housing and Community Opportunity and the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises of the House Committee on Financial Services

"H.R. 3355, THE HOMEOWNERS' DEFENSE ACT OF 2007"

September 6, 2007

Introduction

Thank you, Chairwoman Waters, Chairman Kanjorski, Ranking Member Biggert, Ranking Member Pryce, and Members of the Housing and Capital Markets Subcommittees for inviting me to present the views of the National Association of REALTORS® (NAR) on H.R. 3355, the Homeowners' Defense Act of 2007.

My name is Vince Malta. I am the owner and broker of Malta & Co., Inc., a San Francisco, California firm handling real property sales and management of over 300 residential rental units. I am a member of the California Association of REALTORS® and the National Association of REALTORS® and have held a number of leadership positions in both associations, including serving as the 2006 President of the California Association of REALTORS® and the 2007 Vice-Chair of the Public Policy Coordinating Committee for the National Association of REALTORS®.

The National Association of REALTORS® is America's largest trade association, representing more than 1.3 million members involved in all aspects of the residential and commercial real estate industries. NAR is the leading advocate for homeownership, affordable housing and private property rights. NAR also is a member of the National Catastrophe Policyholders Coalition, an alliance of organizations formed to ensure that the concerns of commercial real estate are addressed in federal catastrophic insurance legislation.

Overview

The availability and affordability of property insurance is, at its core, a consumer issue. The importance of available and affordable insurance to homeowners, commercial property owners and those who would like to own their own home or place of business cannot be

overstated. Unfortunately, it is also something that consumers nationwide – even those who are not in what have traditionally been considered "disaster-prone" areas – now know all too well.

The National Association of REALTORS® strongly encourages Congress to enact a comprehensive natural disaster policy to help property owners prepare for and protect against losses from future catastrophic events. Such a policy would recognize the respective responsibilities of property owners, private insurance markets, and all levels of government in preparing for and recovering from future catastrophic events. My testimony today offers suggestions for what REALTORS® believe must be included in a comprehensive approach to addressing future catastrophic natural disasters.

H.R. 3355, the Homeowners' Defense Act of 2007, defines a process for supporting reinsurance markets nationwide, and as such, marks a solid first step in ensuring the availability and affordability of homeowners insurance in at-risk markets.

Catastrophic Natural Disasters are a National Issue

The catastrophic events of 2004 and 2005 should serve as a wake up call that highlights not only the importance of having insurance, but also that individual property owners, insurance companies, all levels of government, and taxpayers have a role in preparing for and recovering from future catastrophic events. The ongoing recovery from these storms shows that all taxpayers in the country have a stake in a federal natural disaster policy because their tax dollars are funding recovery efforts.

As a result of the 2004 and 2005 hurricanes, attention has focused on Florida and the Gulf Coast states, but other areas of the country are also susceptible to large-scale natural disasters. Any of the following events could cause damage as great as, if not greater than Hurricane Katrina: a repeat of the 1906 San Francisco earthquake, another 1938 "Long Island

Express" hurricane, or a significant seismic event along the New Madrid fault, which extends from northeast Arkansas, through southeast Missouri, western Tennessee, western Kentucky to southern Illinois. While it is true that not all areas of the country are susceptible to the large-scale disaster scenarios above, the effects of these disasters certainly would be felt by all taxpayers.

The Problem Defined: Residential and Commercial Properties at Risk

A strong real estate market is central to a healthy economy by generating jobs, wages, tax revenues and a demand for goods and services. In order to maintain a strong economy, the vitality of residential and commercial real estate must be safeguarded.

Today, insurance availability and affordability concerns are not limited to the Gulf Coast region. We have heard REALTORS® in numerous states, including New York, New Jersey, South Carolina and North Carolina, express concerns about the availability and affordability of property insurance. Their insurance concerns extend beyond homeowners' insurance and include multifamily rental housing and commercial property insurance.

Insurance is a key component to financing the purchase of real estate. Without property insurance, lenders will not lend; without insurance, property owners could be in violation of their mortgage terms. The limited availability and high cost of insurance, therefore, not only threatens the ability of current property owners to hold onto their properties, but also to slow the rate of housing and commercial investment in these communities. Either of these threats could, in turn, further delay the rebuilding of communities on our storm-ravaged coasts.

The inability to obtain affordable insurance is a serious threat to the residential real estate market, impacting not only single family detached homes, but condominiums, co-operatives and rental units as well. New home purchases, resale transactions and housing affordability are affected in the following ways:

- **Homeowners' insurance is a necessary component in securing a mortgage and buying and selling a home.** If a potential homebuyer is unable to obtain or afford the required insurance, the sale will not be completed. As a result, potential homebuyers are excluded from the market.
- **The cost of owning a home is directly tied to insurance costs.** Homeowners are required by their mortgage lenders to maintain homeowners insurance, regardless of its cost. If the homeowner is unable to afford the cost of that insurance, the mortgage is in default and the lender may foreclose. If disaster insurance coverage is required, potential buyers may choose not to purchase a home because the insurance they need is too expensive. If disaster coverage is optional but expensive, owners may choose to go unprotected.
- **Insurance costs impact rent levels.** Insurance costs incurred by multi-family property owners are ultimately passed on to tenants through higher rents. This impacts housing affordability, particularly for low-income renters.

Many of NAR's commercial members in the Gulf Coast have reported problems with commercial insurance availability and affordability. Members have experienced large increases in premiums – in some cases more than four-fold with concurrent increases in deductibles and decreases in coverage – and in other cases, a complete lack of availability. These changes put property owners at greater financial risk to recover from losses, while also affecting property values since dramatic insurance increases often cannot be passed on to tenants.

Often it is the smaller property owner that suffers the greatest. Small owners cannot offset the increases in insurance costs for one property with lower insurance costs in other parts of the country; nor are they able to negotiate a lower multiple property rate. In commercial real

estate, there is a point at which insurance becomes unaffordable – when insurance expenses are so high that the property no longer generates sufficient income to cover expenses. This problem forces many owners to sell their property.

The Homeowners' Defense Act of 2007 (H.R. 3355)

On behalf of NAR, I would like to thank Representatives Ron Klein and Tim Mahoney for their efforts to address the problem of decreasing availability and affordability of property insurance. The Homeowners' Defense Act of 2007, H.R. 3355, defines a process for supporting reinsurance markets nationwide, and as such, marks a solid first step in ensuring the availability and affordability of homeowners insurance in at-risk markets. More importantly, the legislation allows private markets to work effectively where they are already working and allows states to actively participate in assessing and customizing their catastrophe bond needs depending upon the kinds of risks their citizens face.

The Homeowners' Defense Act authorizes two primary activities: (1) The creation of a National Catastrophe Risk Consortium, and (2) the creation of a program to make liquidity and catastrophic loans to state or regional reinsurance programs after a natural catastrophe. The Consortium will act as a clearinghouse for risk data and information and as a facilitator for states, catastrophe bond underwriters and other reinsurance market players. The loan programs would allow a state's catastrophe fund to cover its liability in the event that it is not fully funded, and allow state catastrophe funds to cover damages that exceed its liability.

Both of these programs authorized by the legislation would enhance a state's ability to institute disaster mitigation activities, support the availability and affordability of insurance, and help states and property owners recover faster after a disaster strikes.

The bill authorizes the Secretary of the Treasury to make liquidity and catastrophic loans to states with qualified reinsurance programs and, in the case of catastrophic loans, to FAIR or Windstorm Plans. NAR believes these loan programs would help provide consumers access to homeowners insurance by stabilizing insurance markets, particularly after a disaster has struck.

One of the biggest obstacles to sustained redevelopment in the Gulf Coast region has been the lack of available and affordable homeowners' insurance. One result of the storms of 2004 and 2005 has been a ripple effect in many coastal communities where insurance companies – in an effort to manage risk and decrease their financial liability – have increased premiums, cancelled existing policies, or declined to write new policies. This is happening not just in communities that were directly impacted by Hurricane Katrina, but also in states that have not experienced a hurricane in many years (e.g., Delaware, New Jersey, and New York). Having the ability to tap into a readily available source of federally-backed loan funds will allow states to "smooth out" gaps in coverage, provide confidence to reinsurance and insurance markets, and allow FAIR and Windstorm Plans to offer limited insurance products as a last resort for those homeowners unable to obtain insurance from traditional sources.

The Homeowners' Defense Act of 2007 allows private markets – not federal tax dollars – to accept and pool catastrophe risk through the purchase of catastrophe bonds and reinsurance contracts. This legislation fosters stronger, more competitive insurance markets, which may ultimately provide homeowners with greater access to insurance and lower insurance rates nationwide.

H.R. 3355 addresses one element of what can be a comprehensive national policy to address future catastrophic events. NAR also would like to see legislation such as tax credits to support mitigation activities and increased funding for infrastructure – two areas outside the jurisdiction of the Committee on Financial Services – combined with this bill.

The Importance of a Comprehensive Federal Natural Disaster Policy

States are the appropriate regulators of property insurance markets, but there is a proper role for the federal government in addressing mega-catastrophes. Some disasters are just too large or unpredictable for the private market to deal effectively with the resulting damage. At some level, there is an appropriate role for the federal government to intervene in insurance markets to prevent market disruption and insolvencies among insurance companies. The level of intervention, however, must be set at a level that will not interfere with normal market forces. The difficulty lies in determining the level at which such intervention would be appropriate.

As the catastrophic events of 2004 and 2005 showed, there is the potential at some point in the future that one or more are catastrophic natural disasters will require governmental intervention to prevent a collapse of insurance markets. Perhaps it will be a hurricane that devastates Miami or New York City, an earthquake that rocks the Midwest along the New Madrid Fault Line, or some other catastrophic event. Markets would benefit from the knowledge that there is a backstop to prevent market failure. Preventing market failure is one element of what could be a comprehensive natural disaster policy enacted by the 110th Congress. H.R. 3355 is a piece of that puzzle, but should not be the only piece.

The National Association of REALTORS® strongly encourages Congress to develop and enact a comprehensive natural disaster policy to mitigate exposure to the risks of natural disasters and foster the availability and affordability of homeowners' insurance coverage. NAR supports the development of a comprehensive natural disaster policy that encourages personal responsibility, promotes mitigation measures, ensures insurance availability, and strengthens essential infrastructure (e.g., levees, dams, bridges, etc.).

A comprehensive federal natural disaster policy would promote the availability of affordable homeowners' insurance in disaster-prone areas. Conversely, the lack of a national natural disaster policy has had a measurable direct impact on the availability and affordability of property casualty insurance in many parts of the country. The inability to obtain affordable homeowners' insurance is a serious threat to the residential real estate market – and thus, our economy.

Homeowners and commercial property owners need insurance to protect themselves, their families and their property in case of catastrophe. However, if insurance is not available or affordable, many make the unfortunate, but understandable, decision to purchase only the minimal amount or type of insurance required. The problem with this rational economic decision is that if "the big one" hits, and people are not insured for that type of catastrophe, then the American Taxpayer, that is to say everyone in the country, will pay through taxpayer-funded disaster assistance. Property owners who bear risk should pay a fair share – by obtaining and maintaining adequate insurance coverage.

They also should have confidence that their homes and businesses will survive future catastrophic events. Appropriate mitigation measures can help to create that confidence. Federal and state governments can provide incentives (e.g., tax credits, insurance rate reductions) to property owners to undertake appropriate mitigation measures for their homes and businesses. Research conducted by the Multihazard Mitigation Council of the National Institute of Building Sciences found that a dollar spent on mitigation saves society an average of nearly four dollars.[1]

Finally, an essential part of a comprehensive natural disaster policy is the recognition of the basic responsibility of government at all levels to build and maintain infrastructure.

[1] Multihazard Mitigation Council, "Natural Hazard Mitigation Saves An Independent Study to Assess the Future Savings from Mitigation Activities, Volume 1 – Findings, Conclusions and Recommendations," National Institute of Building Sciences, Washington, D.C. (2005), p.5

Hurricane Katrina showed the importance of properly constructing and maintaining levees to protect lives and property. The tragic collapse of the Interstate 35 bridge in Minneapolis on August 1 provides additional evidence of the need for increased focus on maintaining infrastructure. A recently-released GAO report raises questions about the safety of railroad bridges and tunnels.[2] Infrastructure development and maintenance is an essential government function and must be an integral part of a comprehensive plan to address future catastrophic events.

NAR believes that it is in the best interests of all Americans to have a comprehensive federal natural disaster policy that includes aggressive mitigation and appropriate assumption of risk so that affordable insurance for homeowners and commercial properties is available. Creating a comprehensive natural disaster policy is essential in the coming years. There is no guarantee that 2007 or any future years will be as benign for natural catastrophes as 2006. The question is not whether there will be another Katrina-like event in size and scope of destruction, but when. As we have learned, it is far less costly to prepare ahead of time than to fund recovery efforts.

NAR encourages the consideration of additional proposals that would provide incentives for property owners to undertake mitigation measures, allow individuals to establish catastrophe savings accounts to pay for losses resulting from catastrophic events, strengthen the nation's infrastructure, and ensure the long-term viability of the National Flood Insurance Program. NAR believes that all reasonable proposals should be considered as part of a comprehensive solution to address future catastrophic events. A comprehensive solution to the insurance availability and

[2] Government Accountability Office, "Railroad Bridges and Tunnels: Federal Role in Providing Safety Oversight and Freight Infrastructure Investment Could Be Better Targeted," GAO-07-770, Washington, D.C. (August 2007).

affordability crisis will take a combined effort of several House Committees including Financial Services, Transportation and Infrastructure, and Ways and Means.

Elements of a Comprehensive Natural Disaster Policy

NAR encourages Congress to develop a comprehensive natural disaster policy that encourages personal responsibility, promotes mitigation measures, ensures insurance availability, and strengthens critical infrastructure (e.g., levees, dams, bridges, etc.). NAR supports the creation of a federal natural disaster policy that:

1) Protects property owners by ensuring that transparent and comprehensive insurance coverage is available and affordable, with premiums being reflective of the risk involved;

2) Acknowledges the importance of personal responsibility of those living in high-risk areas to undertake mitigation measures and purchase adequate insurance;

3) Provides property owners adequate incentives to undertake mitigation measures where and when appropriate;

4) Acknowledges the importance of building codes and smart land use decisions while also emphasizing that proper enforcement of both is best left in the hands of state and local governments;

5) Recognizes the role of States as the appropriate regulators of property insurance markets while identifying the proper role of federal government intervention in cases of mega-catastrophes; and

6) Reinforces the proper role of all levels of government for investing in and maintaining critical infrastructure including levees, dams, and bridges.

Conclusion

Thank you again for inviting me to present the views of the National Association of REALTORS® on H.R. 3355 to the Subcommittee on Housing and Community Opportunity and the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises. The National Association of REALTORS® encourages Congress to develop a comprehensive approach to natural disaster preparedness that encourages personal responsibility, promotes mitigation measures, ensures insurance availability, and strengthens the nation's infrastructure. NAR believes that the Homeowners' Defense Act is a positive and timely first step in the development of such an approach.

Passage of an appropriate comprehensive national disaster policy is a top legislative priority for REALTORS® nationwide. We stand ready to work with you, Chairwoman Waters, Chairman Kanjorski, the Committee on Financial Services and others in Congress to develop a responsible natural disaster policy that addresses the needs of consumers, the economy and the nation.

RAA
REINSURANCE ASSOCIATION OF AMERICA

STATEMENT

TESTIMONY

OF

FRANKLIN W. NUTTER
REINSURANCE ASSOCIATION
OF
AMERICA

THE HOMEOWNERS DEFENSE ACT
H.R. 3355

BEFORE

THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY AND THE SUBCOMMITTEE ON CAPITAL MARKETS

September 6, 2007

1301 Pennsylvania Ave., N.W.
Suite 900
Washington, D.C. 20004-1701
202/638-3690
www.reinsurance.org

Chairmen Waters and Kanjorski, Ranking Members Biggert and Pryce, and Members of the Subcommittees:

My name is Frank Nutter and I am President of the Reinsurance Association of America (RAA). It is an honor to appear before you on behalf of the RAA. The RAA is a national trade association representing property and casualty companies that specialize in assuming reinsurance. Together, RAA members write nearly two-thirds of the reinsurance coverage provided by U.S. property and casualty reinsurers and affiliates.

Reinsurance is commonly referred to as the insurance of insurance companies. Reinsurance plays a critical role in maintaining the financial health of the primary marketplace, and ensuring the availability of property and casualty insurance for U.S. consumers and business. Reinsurers have assisted in the recovery after virtually every major U.S. catastrophe over the past century. For natural disasters, typically one-third of the insured losses were absorbed by the reinsurance industry. Fifty percent of the 2005 losses associated with Hurricanes Katrina, Rita and Wilma ultimately were born by the private reinsurance market.

The RAA appreciates the opportunity to testify on H.R. 3355, The Homeowners Defense Act of 2007. Clearly any natural disaster financing solution is an issue of utmost importance to the RAA. While the RAA does not support this legislation, and has significant concerns that provisions of this legislation would unnecessarily crowd out the private reinsurance market, we do agree with some of the principles in the legislation, and pledge to work with the Committee to improve it as it moves through the legislative process.

The natural catastrophe events of 2004-2005, related developments in insurance and reinsurance markets, and state legislative activity in 2007, have focused interested communities, public and private, on the appropriate relationship of government and the private sector. In this regard, I commend Representatives Mahoney and Klein for their leadership in exploring solutions that seek to maximize the resources of both in addressing coastal insurance matters. It is in the interest of private sector insurers and government officials to explore solutions to the concerns of coastal residents about the cost of their insurance and to non-coastal residents who, as is the case in Florida, are asked to help finance shortfalls in state insurance programs and, in the case of taxpayers, are asked to fund government disaster recovery and repair whether or not they live in disaster-prone areas.

Both the federal government and the private insurance sector have committed extraordinary resources in disaster recovery efforts. Indeed a partnership exists between the federal disaster recovery efforts and the insurance industry's contractual and financial stake in the recovery of its insureds from natural disasters. Published reports reviewing the 2005 hurricane season show that the federal government committed nearly $30 billion to the Department of Defense for immediate disaster recovery, nearly $20 billion to the National Flood Insurance Program for its insured's claims, $18 billion to infrastructure repair, $17 billion to Block Grants for community initiatives, $13 billion to temporary housing and $6 billion for loans. The insurance and the global reinsurance industry contributed nearly $70 billion in rebuilding and recovery for homes and commercial buildings of its policyholders. The roles are fully complementary: the federal government focused on its traditional role in disaster response, assistance, public

infrastructure and the NFIP; the insurance industry provided recovery financing for the homes and businesses of its insureds.

It is important for the Committee to understand that, notwithstanding the extraordinary losses from natural catastrophes in 2004 and 2005, the private insurance and reinsurance sector proved exceptionally resilient. The record losses for insurers reduced insurer earnings in 2004 and 2005, but U.S. property and casualty insurers increased capital from $359 billion at year-end 2003 (prior to the hurricane seasons) to $437 billion at year-end 2005 and $500 billion at year-end 2006. Despite record losses after Hurricane Katrina, an additional $41 billion of new capital entered the (re)insurance business to support and underwrite U.S. natural catastrophe risk, including $12 to 15 billion of new securities for catastrophe risk issued by the capital markets. The capital markets and the insurance and reinsurance industry have shown their ability to meet natural catastrophe risk transfer needs of insurers and consumers when market dynamics are allowed to work.

We are pleased that the principle of utilizing the private reinsurance and capital markets underlies HR 3355 as introduced by Representatives Klein and Mahoney. Spreading the risk of natural catastrophes to the private sector, rather than state insurance programs, is the best long-term solution to addressing catastrophe exposure and cost issues. Most states, in fact, embrace this same goal of de-populating state wind programs and residual market mechanisms. In fact, the growth in residual markets in states generally reflects a market that is not functioning properly to spread risk or which does not reflect a premium based on risk exposure. Many states have taken action to address market issues based on increasing private market participation. South Carolina introduced policyholder or catastrophe savings accounts to assist consumers and address cost issues; Louisiana and

South Carolina addressed rating and regulatory matters by encouraging greater competition among insurers rather than rate controls that discourage private market competition; Louisiana has committed financial incentives for insurers to underwrite or take policies from the residual market and write-in coastal areas. Several states have also improved building codes and their enforcement as part of the long-term solution to catastrophe risk.

The alternative to competitive private markets are state insurance and reinsurance programs, such as in Florida, that encourage state entities to replace or compete with the private sector by underpricing catastrophe risk. These programs serve to concentrate catastrophe risk in a state rather than spread it to the global reinsurance and capital markets. This turns sound risk management on its head. If government reinsurance programs do not collect premiums based on the catastrophe risk of the insurers that transfer risk to it, those programs will be financed with public debt rather than on the books of the private sector. State programs that do not collect adequate, risk-based premiums up front, such as in the case of the Florida Hurricane Catastrophe Fund, cannot afford to lay off the risk to the capital or global reinsurance markets. They must rely on the issuance of bonds and have the taxpayers and other insurance consumers to pay off the debt and subsidize catastrophe exposed insurers.

A major concern the RAA has with HR 3355 is that it appears to provide incentives for the creation of more such state catastrophe reinsurance programs. We understand the legislation reflects the concern that state programs may have liquidity issues by providing that the federal government be a lender of last resort to ensure that state programs meet their cash needs. This is not an issue for most states with catastrophe exposure. They

have chosen not to create a Florida-style reinsurance program. Their residual markets or wind pools, and in its case, the California Earthquake Authority, rely on private reinsurance and capital markets for risk transfer and on assessments on insurers as a means to access cash in the event the program does not have sufficient liquidity.

Reinsurance markets embrace and, in fact regularly reflect, the principle contained in Title I of HR 3355: insured catastrophic risk can and should be transferred to the private market rather than concentrated in a state sponsored program. We do not understand why a federally-chartered corporation or consortium is necessary to achieve this spread of risk when this is already done in the private market. While this is difficult if not impossible to achieve with under-funded or under-capitalized state programs (only Florida arguably has a fund that would qualify under the proposed legislation), reinsurance brokers and intermediaries to the capital markets regularly perform the functions described for the proposed federally-chartered consortium. In fact, Florida's own financial intermediary did approach the State Board of Administration with a risk transfer proposal for the Florida Hurricane Catastrophe Fund to transfer Fund exposure to the private sector. Florida rejected the offer based on its' proposed cost relative to what the state fund collected from ceding insurers. It is unclear why a federal corporation or consortium is needed to replace these private market intermediaries. On numerous occasions, states, in particular Florida, have explored the consortium's stated goal of risk transfer of catastrophe exposure among the states. Although there appears to be no legal impediment for them to do so, to date states have chosen not to join together to pursue this. Rather, reinsurers and capital markets now serve to assimilate risk among various risk bearers, public and private, as an efficient way to achieve a spread of risk and competitive market

pricing. To achieve this, financial intermediaries and brokers now serve the valid functions the consortium is designed to have.

The consortium's underlying finances and value to consumers should be further analyzed. The authors of the bill are to be commended for the principle that the federal government will have no liability under the program. Yet, it is difficult to understand how a federally-chartered corporation or consortium that does not bear risk on its own account can issue securities (government securities?) and not expose the federal government to liability. Another critical question that should be asked is what are the expected savings to consumers? The consortium notwithstanding, it should be expected that the capital and reinsurance markets will require a risk based rate for assuming a state program's, or a consortium of state program's, catastrophe risk. The savings, if any, from a federally-chartered enterprise, which serves as a "conduit," would not seem to have much savings to pass along. If, instead, the goal of the consortium is to encourage uniformity for laying off risk into the capital markets, the Committee should hear from the Chicago Mercantile Exchange or the New York Mercantile Exchange, both of which have introduced trading in catastrophe contracts within the past year. Uniformity of contracts for trading is a stated goal for each exchange platform.

The RAA has significant concerns with Title II of this legislation. We believe Title II will encourage the creation of state catastrophe reinsurance funds and unnecessarily crowd out the private reinsurance market. The principle stated in Title II of HR 3355 that reflects concerns over the liquidity of state reinsurance programs is valid, but currently of limited application. The Florida Hurricane Catastrophe Fund, the only fund that arguably qualifies under the program, is heavily exposed to debt financing. The Florida Fund is

expected to have $2.4 billion of cash at year-end and an additional $55 billion in debt financing capacity, if needed, to pay claims. This assumes, of course, that the capital markets will assume the debt when authorized and issued. No other state has a reinsurance fund. Hawaii enacted one after Hurricane Iniki in 1994, but closed it two years later as private market conditions rebounded. California does not have a reinsurance fund nor liquidity issues, but has a consumer earthquake program that aggregates the earthquake risk and, through private sector financial intermediaries, places much of it in the reinsurance market or into capital market products. Other state catastrophe programs, wind pools or residual markets which provide consumer coverage, not reinsurance, are financed by charging premiums to cover their risk, laying off risk into the reinsurance markets and, if necessary, assessments on insurers.

The liquidity provisions of the bill will likely incent states to create reinsurance programs, like Florida's, based on under-funded debt. With the carrot of low interest loans from the federal government, states will create reinsurance programs which to date they have chosen not to do. The risk of loss will no longer be spread through the private reinsurance market, but instead, will be concentrated within that particular state and its insurance consumers. States should encourage risk bearers, public and private, to base their financing on risk-based rates and, as appropriate, laying off risk to the capital markets and reinsurance. Unfortunately, the likely effect of the liquidity provisions of Title II is to transfer risk from consumers who live in catastrophe prone areas to federal taxpayers, most of whom have little, if any, catastrophe exposure that they do not now fully fund through their own insurance premiums. If the goal of the liquidity portion of the bill is to address "timing risk" (the risk that the loss event will occur before sufficient funds are collected), existing consumer-based wind pools and residual markets, like

private insurers, address this now through the transfer of risk to reinsurers and capital markets— a goal of the legislation, but potentially undermined by low-cost federal loans.

Our belief is that the federal loans will reduce the need for private reinsurance and that this is not sound public policy. Appropriately, HR 3355 does contain language that its goal is not to make loans unless state programs cannot access capital at a lower cost. If the Committee wishes to ensure that the private reinsurance sector and captive markets is maximized before any federal debt is issued, this provision should be further clarified to ensure that the liquidity provisions do not compete with the private sector, but serve as a last resort when reinsurers and capital markets are unwilling or unable to assume a state program's own debt or catastrophe exposure on competitive market terms.

The RAA cannot support this legislation as introduced because of the emphasis on encouraging the creation of state catastrophe reinsurance funds. If the Committee chooses to further consider HR 3355, we recommend changes to the bill that will facilitate its stated goal of improving private market access. A few of these suggested amendments are described below.

We support the provisions of the bill giving the Secretary of Treasury significant authority over state programs that might use the consortium or the liquidity provisions. However, the criteria for state programs need to be enhanced. A federal role to protect the federal exposure will be essential. To achieve the bill's goal of promoting private reinsurance and capital markets, the Secretary should have authority to see that risk-based rates and competitive market conditions exist in participating states. As reflected in part in the bill, this should include provisions that the Treasury be authorized to address

underlying policy coverage and see that competitive rating systems, rather than price controls, should be in place in those same states. States should not be permitted to cross subsidize coverage among lines of insurance not covered by the state program or by consumers who do not benefit from the state program.

Of utmost importance is that these loans should only trigger for a major catastrophic event. The size of such events varies dramatically from state to state. The triggers for the loans in H.R 3355 are set at 150% of homeowners' premiums. This is very small event in most states and would result in borrowing for many events that historically have been easily absorbed by the private market without any disruption in capacity or pricing. In fact, many hail storms and tornados would fall in this category. To address this, the loans should trigger on the greater of (1) a dollar amount of insured homeowners catastrophe losses that exceeds expected annual losses, (2) a minimum event size (a 1 in 100 to 1 in 250 year event is standard practice for insurers and rating organizations) or (3) the capacity of the state fund, whichever is greater. The Treasury Secretary should have authority to analyze the capacity of private marketplace and raise these trigger levels if they infringe on the private market. We support inclusion in the findings and purposes of this legislation, language that states the legislation must not interfere with the private marketplace. We also support language that ensures private market participants and interested parties have the opportunity to submit relevant information to the Treasury Secretary in setting the trigger levels of these loans.

We are also very concerned that the interest rate on the loan will be so low that states will game the system by creating reinsurance funds and spreading the risk of loss by securing low interest loans, rather than purchasing reinsurance. The Committee must consider the

interest rate of this loan and ensure that it is not so low that it provides a disincentive for the state to purchase competitive market reinsurance or catastrophe securities. All liquidity loans should have the full faith and credit of the state that sponsors the state program, not just non-qualifying state programs that apply for loans.

We recommend that the legislation include a private market "right to participate" procedure. In sum, an administrative procedure could be set up under Title II that provides the private sector, including private insurers, reinsurers, capital markets and or a consortia of such entities, an opportunity to provide pre-event borrowing or risk financing needs of the state catastrophe funds and the residual markets. The pre-event loans would only be provided if the state program demonstrated that they were unable to secure private capital.

We also ask the Committee to examine where the consumer savings, if any, are to be applied. The legislation provides no guarantee that the state catastrophe funds will pass along the savings of the low-interest loans and that homeowners and consumers who are demanding more affordable insurance will benefit.

The RAA looks forward to working with the Committee to improve this legislation and we very much appreciate the opportunity to testify today on this most important issue.

September 6, 2007

Testimony of

Dan Ozizmir,
Managing Director and Head of Asset-Backed Securities/Insurance-Linked Securities/ Environmental and Commodity Markets, Swiss Re

on
"Role of Cat Bonds in Managing Catastrophe Risk"

before

The Capital Markets, Insurance, and Government Sponsored Enterprises

and

The Housing and Community Opportunity

Subcommittees of the

Financial Services Committee,

US House of Representatives

I would like to thank Chairman Kanjorski and Chairwoman Waters for holding this hearing on HR 3355, the Homeowners Defense Act of 2007. My name is Dan Ozizmir. I am the Managing Director and Head of Asset-Backed/Insurance-Linked Securities/Environmental and Commodity Markets for Swiss Re Capital Management & Advisory. Swiss Re Capital Management & Advisory is a subsidiary of Swiss Re, the largest reinsurer in the US and the world. Swiss Re Capital Markets is a member of the Securities Industry and Financial Markets Association. Swiss Re is a member of the Reinsurance Association of America.

Swiss Re has been a leader in insurance-linked securities market. We have underwritten more catastrophe bonds than any other broker dealer in the last five years. And, in 1997, sponsored one of the first catastrophe or cat bond transactions, SR Earthquake Ltd. This market provides solutions for a broad range of risks including both life insurance risk, catastrophe risk, as well as other non-life risks. We continue to have a strong and strategic interest in the insurance-linked securities market and participate in many ways, including by:

- Acting as an arranger of solutions (for example, structuring and underwriting catastrophe bonds),
- Trading insurance-linked securities and other insurance risk in many different forms, and
- Accessing the risk market as an alternative source of capital (e.g., sponsoring a life insurance embedded value securitization)

We believe that the insurance-linked securities market complements rather than competes with our core reinsurance businesses.

Five years ago I testified in front of many of you and described the insurance-linked securities market as a small but strategically important source of capital for Swiss Re. Today this market not only remains strategically important, but it has grown from approximately $7 billion outstanding in 2002 to approximately $32 billion outstanding in 2007, and plays a meaningful role in making reinsurance and insurance more available and affordable. Back then, only a handful of international reinsurers and U.S. insurers had tapped into the market. Today, many major U.S. property insurers have accessed the market. Even if they have not done so directly, most of their reinsurers have done so and the insurers have thus indirectly accessed the same capacity.

My comments today will focus only on the current and possible future direction of the cat, bond segment, which represents $12 billion of the outstanding $32 billion in insurance-linked securities. I will do so by briefly answering:

- What is the purpose of a cat bond?
- What motivates investors?
- How do cat bonds work?
- What is the current and future impact of the cat bond market?

What Is the Purpose of a Catastrophe Bond?

Large catastrophes in the U.S. and worldwide have the potential to cause insured losses in the tens or even hundreds of billions of dollars. For instance, Hurricane Katrina caused over $40 billion in losses in 2005. Cat bonds exist to help insurers make sure they can honor their policy obligations to pay claims to policyholders after such catastrophes.

Cat bonds also help reinsurers, as well as corporations and government entities but for simplification my discussion will focus primarily on insurers as sponsors.

Besides cat bonds, insurers have a number of other tools at their disposal to manage their peak catastrophe risks including:

- Raising more equity capital by selling more company stock;
- Reinsuring risks to the reinsurance markets; and
- Limiting risks via the underwriting and asset management process.

While not an exact substitute for any of these approaches, transferring risks to the cat bond market complements these other tools in particular for certain peak catastrophe risks to the insurance industry, such as East and Gulf Coast hurricanes and California earthquakes.

An insurer needs to hold significantly more equity to underwrite peak exposures, like a Florida hurricane or California earthquake, than it does to underwrite non-peak exposures such as a single house fire or auto accident. As the insurer needs to pass on its cost of capital to policy holders, this increased cost of capital helps explain why insurance costs more in peak exposure zones even if the probability of loss is equal.

Cat bonds offer other benefits beyond merely transferring the risk to another party. Unlike traditional reinsurance, catastrophe bonds can create multi-year capacity at a fixed price and eliminate default risk.

In addition, in some catastrophe bond structures, insurers may receive recoveries well before paying claims (sometimes years before) creating a liquidity cushion. While generally only a short gap exists between paying claims and recovering reinsurance, this timing advantage is appealing to some issuers.

What Motivates Investors?

So we know why insurers want to sponsor cat bonds but why do investors buy them? To answer this, we must first talk about who invests. Direct investment is limited to qualified institutional investors. The largest investors include large fixed income money managers, dedicated funds, banks, and multi-strategy hedge funds. By dedicated funds, we mean hedge funds or money managers with a single strategy of

investing in insurance-linked securities. Note that insurers and reinsurers as well as private equity firms also play a minor role. By way of geography, a little over 60% of buyers are based in the U.S., about one-quarter in Europe, about 10% in Bermuda with the remainder primarily in Asia.

While investor motivations vary, the primary motivation for investing is to add diversification to an investment portfolio and to achieve a higher risk-adjusted return for an overall portfolio. Adding catastrophe bonds to a fixed income portfolio reduces the expected standard deviation for the portfolio, improving the portfolio's overall risk-return profile. In other words, the return stays the same but the portfolio risk goes down.

This occurs because defaults on corporate bonds and natural disasters are assumed to be largely uncorrelated. As an example, historically there has been essentially no relationship between earthquakes and corporate bond defaults. Even in a non-default context, catastrophe bonds provide diversification for investors. We have seen this during the recent turmoil in the credit markets, where catastrophe bond prices have remained unaffected.

The development of third party cat models has also attracted more investors. For any given investment, they can review third party catastrophe models also reviewed by the rating agencies. These models assist investors in evaluating the catastrophe risk without themselves having to become seismologists or meteorologists.

Note that in contrast, neither the rating agencies nor investors have become comfortable with the existing models for terrorism risk, which is why we continue to believe that neither catastrophe bonds nor other insurance-linked securities can meaningfully contribute to the capacity shortage in this area at this time.

Five years ago when I testified, I explained why many large institutional investors stood on the sidelines of this market notwithstanding these diversification benefits. Today, a few remain on the sidelines but most large U.S. institutional investors participate in the market, even after several bonds suffered large mark-to-market losses following Hurricane Katrina. A "mark-to-market loss' means that secondary trading has established lower values for the bonds even before any bonds actually lose any principal. As yet, no bonds have actually lost principal from Katrina even though the market expects them to do so.

Participation may mean investing in the cat bonds or investing in a dedicated fund that invests in bonds. In coming years, we expect participation to spread worldwide. Further, existing investors will increase their participation in the sector. I will return to this issue of participation later in my testimony and offer a prediction as to the expected market growth in the next 5-10 years.

How Do Catastrophe Bonds Actually Work?

The basic catastrophe bond structure serves a simple purpose: allow insurers to buy collateralized reinsurance and investors to buy rated bonds which have a risk of default based on the reinsurance risk.

Here is how a typical transaction would work: First an insurer would establish a special purpose vehicle or issuer. The insurer enters into a reinsurance agreement with the issuer. The issuer sells rated bonds and places the bond proceeds in trust to collateralize, or secure, the reinsurance agreement. The issuer pays interest on the bonds using reinsurance premiums received from the insurer and the investment returns on the assets in the trust.

If a catastrophe occurs before the reinsurance contract ends, the parties will look at the terms of the reinsurance contract to determine if the insurer is entitled to a recovery. If so, the assets are converted to cash and paid to the insurer as required. At maturity, the issuer repays any remaining trust assets to the investors. In the absence of a claim, the investor receives the return of the entire bond principal.

The trigger for determining whether the issuer has to pay the insurer following a catastrophe can take the form of an indemnity trigger based on the insurer's actual losses or the form of a non-indemnity trigger. Non-indemnity triggers are designed to serve as a proxy for the insurer's actual losses in a way that the investors find more transparent. In a non-indemnity trigger deal, the insurer takes the risk that the non-

indemnity trigger overstates or understates actual losses. This risk is known as basis risk. Trigger choice depends on a tradeoff between transparency, pricing, and basis risk. We do not believe there is one single correct decision.

What Is the Current and Future Impact of the Catastrophe Bond Market?

Cat bonds play an important role in making property insurance in the U.S. more available and affordable. In 2007 thus far, the market has provided over $5 billion in new catastrophe capacity. This is already slightly more than the total for all of 2006. This capacity growth has occurred in spite of very substantial interest spread declines which make bonds less attractive.

Several factors drive this growth. First, existing investors like owning catastrophe bonds and have dedicated additional funds in recent years and many new investors are following them. Second, sponsors are more comfortable with the technology and like such benefits as multi-year collateralized capacity and elimination of any timing lag on payments. Further, price for protection has dropped.

Most of this new capacity supports U.S. natural catastrophe risk. At present, the approximately $12 billion of outstanding cat bond issuance offers nearly $23 billion of capacity. This is possible due to the overlapping coverage provided by so-called 'multiperil' bonds. From this, over $15 billion of capacity is provided for U.S. natural catastrophe risk.

We expect the cat bond market to continue to grow along with the broader market for tradable insurance risk. The cumulative average growth rate between 2002 and today as measured by the total amount of cat bonds outstanding is 35%. If the market continues to grow at even half this rate for another 5 years, the amount outstanding would be $56 billion. And there is plenty of room to grow - the $12 billion outstanding represents a tiny percentage of the overall fixed income markets. For example, the outstanding amount of U.S. dollar denominated bonds equaled $27 trillion [according to FINRA]. Even if we compare catastrophe bonds rated in the BB range to comparably rated U.S. dollar denominated bonds, the ratio is roughly 1 to 100. Clearly, these numbers dwarf even the potential insured losses from even the largest hurricanes and earthquakes.

We do not believe that any material regulatory barriers exist which prevent further growth in the cat bond market. The investors, sponsors, rating agencies and underwriters have settled on a series of structures that work reasonably well and which continue to evolve. Any changes designed to perfect these slightly imperfect structures would have only a very modest impact on market growth if any. This contrasts with other sectors of the insurance-linked securities market where significant regulatory impediments remain.

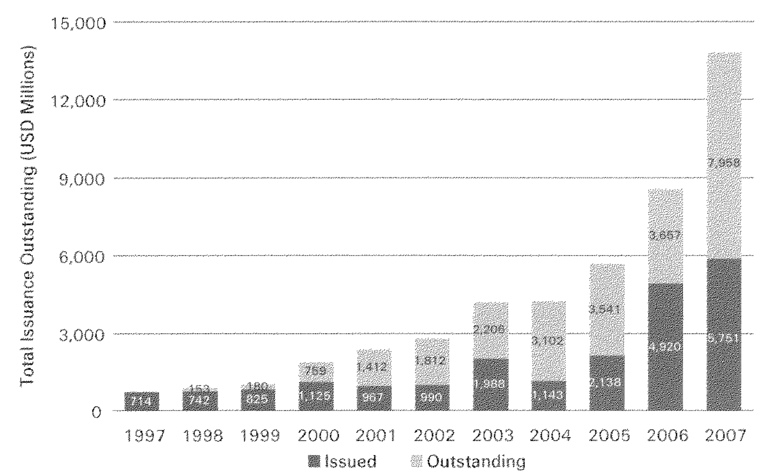
It is important to mention that a number of other capital market products also provide additional natural catastrophe capacity. These products include industry loss warranties, exchange traded contracts, insurance derivatives, and capital markets quota shares or "sidecars" to the extent backed by capital other than equity investors (e.g., the mezzanine or debt portion of a sidecar). We note that most equity investors do not provide meaningful additional capacity when investing in sidecars because such investments largely substitute for equity contributions to insurers or reinsurers. In total, adding the impact of these other products to the impact of the cat bond market, the $12 billion in cat bonds outstanding grows to approximately $20 - 25 billion of capacity created.

Conclusion

In our view, cat bonds and related solutions play an important role in assuring the continued availability of affordable insurance to policyholders in areas exposed to peak perils such as East Coast hurricanes and California earthquakes. Swiss Re believes this market will continue to grow and will assist in growing insurance capacity throughout the United States and around the world. It is Swiss Re's view that, given time, the private market place will adjust and innovate. We also would like to caution the subcommittees to reject any government mechanisms which ignore risk pricing and the cost of capital. Such proposals will crowd out market development and will only compound the challenges. Thank you for the opportunity to express our views on this very important matter.

Swiss Re

Total Non-Life Cat Bonds Outstanding by Year



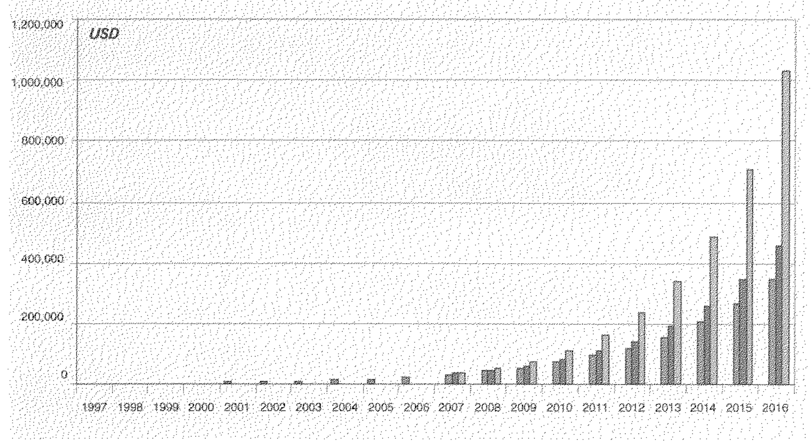
As of August 13, 2007
Source: Swiss Re Capital Markets

Swiss Re

Potential Growth Rate: Incentive for Creating a Substantial Market

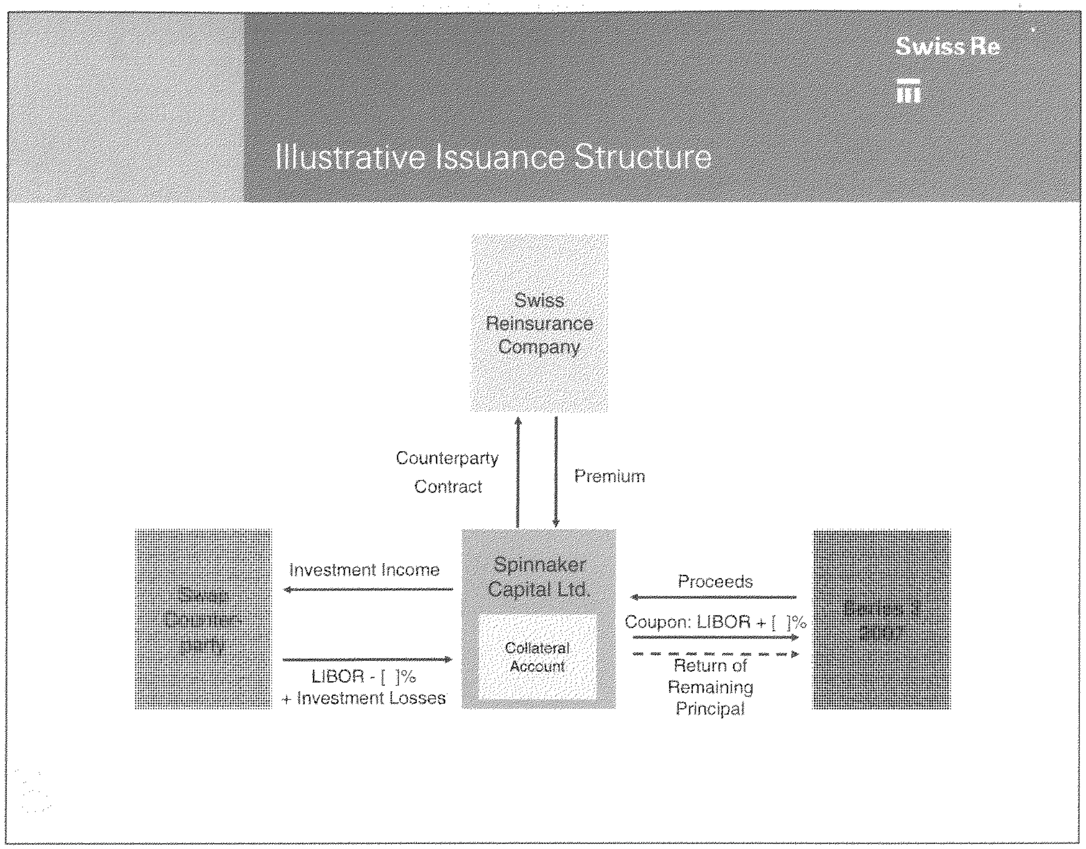
The compound annual growth rate from 1997 – 2006 is approximately 45%, which translates to a total outstanding amount of 25B

- Actual Outstanding ILS (45%[1])
- Projected Outstanding ILS (45%[2])
- Projected Outstanding ILS (34%[3])
- Projected Outstanding ILS (30%[4])



(1) Actual historical compound annual growth rate (1997-2006)
(2) Projected outstanding using actual historical compound annual growth rate
(3) Projected outstanding using 75% of actual historical compound annual growth rate
(4) Projected outstanding using 66% of actual historical compound annual growth rate

As of December 29, 2006
Swiss Re Capital Markets
Proprietary and Exclusive


Swiss Re
Illustrative Issuance Structure
Swiss Reinsurance Company
Counterparty Contract
Premium
Swap Counter-party
Investment Income
LIBOR - [ ]%
+ Investment Losses
Spinnaker Capital Ltd.
Collateral Account
Proceeds
Coupon: LIBOR + [ ]%
Return of Remaining Principal
Series 1 2007

THE COMMONWEALTH OF MASSACHUSETTS
MASSACHUSETTS HOUSE OF REPRESENTATIVES
STATE HOUSE • BOSTON, MA 02133

MATTHEW C. PATRICK
STATE REPRESENTATIVE
3RD BARNSTABLE DISTRICT
STATE HOUSE, ROOM 540
TEL (617) 722-2090
FAX (617) 626-0263
DISTRICT OFFICE: (508) 540-6308
E-MAIL: REP.MATTHEWPATRICK
@STATE.MA US

COMMITTEES:
TELECOMMUNICATIONS,
UTILITIES AND ENERGY
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[testimony9 1 07drft]

HR 3355, A BILL TO ENSURE THE AVAILABILITY AND AFFORDABILITY OF HOMEOWNERS' INSURANCE COVERAGE FOR CATASTROPHIC EVENTS "HOMEOWNERS' DEFENSE ACT OF 2007"

TESTIMONY

By Massachusetts Representative Matthew C. Patrick, Third Barnstable District

My name is Matthew Patrick, I am the State Representative for the Third Barnstable District in the Massachusetts legislature and I am here to testify in favor of HR 3355. Thank you for giving me this opportunity to describe the homeowners' insurance crisis in Massachusetts and how HR 3355 will benefit the Commonwealth of Massachusetts.

Beginning in late 2003 the price of homeowners' insurance started increasing for residents and businesses of Cape Cod. On Martha's Vineyard and Nantucket the increases began earlier. Other coastal areas of Massachusetts have more recently felt the effects of the increasing cost of homeowners' insurance. The price of insurance in these areas has gone up more than 150 percent in three years for many homeowners.

Several retail homeowners' insurance companies have left the coastal market citing the cost they must pay for reinsurance and the increase in projections by catastrophe models for hurricane damage. Reinsurance has increased due to the predictions of proprietary computer models as well as 2004 and 2005 hurricanes in the United States and other worldwide catastrophes.

Today, forty four percent or 57,527 homes on Cape Cod and the islands are now with Massachusetts FAIR Plan, the insurer of last resort. That's up from 5,614 in 2001 or better than a one thousand percent increase. The average FAIR Plan premium on the Cape and islands is now just over $1,739. The FAIR Plan is no longer just the insurer of last resort for economically

troubled areas. It has become the only option for many residents in coastal areas. The FAIR plan is increasing its rates to keep up with its costs of reinsurance. It has won a 25% increase from the insurance commissioner and has applied for a second 25% increase.

The FAIR Plan is spending more and more on reinsurance that has gone up every year. In 2005 the FAIR Plan spent $17.5 million for $500 million worth of reinsurance. In 2006, they spent $43 million for $455 million in reinsurance and in 2007 the FAIR Plan spent $75 million for $979 million in reinsurance.

This homeowners' insurance problem is moving progressively up along the coasts of Massachusetts. Beginning in 2007, legislators from the south coast of Massachusetts (Fall River to Wareham) and the south shore (Quincy to Plymouth) received a growing number of complaints from their constituents about the rising cost of homeowners' insurance.

Before you are swept up in the assumption that everyone is rich on Cape Cod, consider the following facts. Rising homeowners' insurance costs have dramatically affected the affordability of housing for seniors on fixed incomes who represent twenty five percent of the Barnstable County population. Some senior citizens, who have paid off their mortgages, have invited disaster by not purchasing homeowners' insurance because the price has gone up so high.

In addition, sixty percent of the Barnstable County workforce have average incomes of around $20,000 according to 2000 US census data. Even accounting for an increase in the interceding years most families are having trouble with the rising costs of homeowners' insurance and were struggling to stay afloat already. The cost of living in Barnstable County is nearly on a par with the Boston Metropolitan area. According to Crittenton Women's Union Cost of Living Study, a family of four need $57,919 to cover minimum, "no frills" needs in Barnstable County. The cost of living requires that both spouses work to even approach that figure and then there is an $18,000 affordability gap. http://www.liveworkthrive.org/calculator.php

This affordability gap is only exacerbated by the escalating cost of homeowners' insurance. We hear from our constituents on an almost daily basis, calling to say that they are being forced to sell and move because of the high cost of their insurance premium. Barnstable County is losing its middle class that has been struggling to survive. For many the double digit increases in insurance is the proverbial straw breaking the camel's back.

The increases are affecting homes several miles from the coast, not just within immediate vicinity of the coast. This is where the working families of Cape Cod, Barnstable County, live, not in the expensive, high end ocean view neighborhoods.

As mentioned earlier the increases are being driven by high cost of international reinsurance companies and their reliance on private computer models. Three private computer models are projecting higher risks because there is more building and more expensive building along the coast line and because of the impacts of global warming which include more intense storms and sea level rise.

The Cape Cod State Legislative Delegation has moved forcefully to remedy this problem by endorsing Senator Robert O'Leary's Catastrophic Reinsurance Fund, S 624. The bill will create a reinsurance pool for private insurance companies doing business in the Commonwealth and the FAIR Plan. By doing so we hope to maintain the private sector's role as the primary risk bearer and stabilize the rising cost of homeowner's insurance. We have gained the support of many of our south coast and south shore colleagues and HR 3355 will help us in our effort to pass the legislation.

The Klein and Mahoney bill, HR 3355 will be very helpful to our efforts. HR3355 will provide us with a backup in the event of an extreme catastrophic event that depletes our reinsurance pool before we have it fully funded which will be seven to ten years. It will also help us finance the fund by issuing bonds if the Commonwealth has trouble on its own.

While helpful as drafted, we would like to see HR 3355 provide more emphasis on tax exempt status for the Massachusetts Catastrophic and similar funds in other states.

The provision of dependable and affordable homeowners' insurance is a severe problem for Massachusetts and other coastal states. Homeowner's insurance is a necessity in today's society and if the private sector can't provide a viable product for average Americans, it falls to state and federal governments to assist in doing so. We believe that the establishment of our state catastrophic fund, backed by the federal fund will result in a calming of the market because the insurance companies will be purchasing reinsurance from the Commonwealth at a lower cost than if bought through private reinsurers – a fund that will continue to grow until there is a catastrophic event. Once the cost of reinsurance is stabilized, we believe that market forces will cause many companies who have left coastal areas to recommence writing business in these areas. Cape Cod and coastal Massachusetts is a fundamentally desirable place to do business. Homes are well built and maintained, major storms are infrequent and people pay their premiums. HB 3355 will help us to help market forces to work!

HB 3355, A bill to ensure the availability and affordability of homeowners' insurance coverage for catastrophic events, compliments our efforts on the state level. With it we will be able to provide a reinsurance pool for both the FAIR Plan and private homeowners' insurance companies.

We would only ask that the tax exempt status be affirmed leaving no question in the matter.

Thank you for this opportunity to present my view.

Respectfully,

Matthew C. Patrick

Testimony of Commissioner J. P. Schmidt
Hawaii Insurance Division

On Behalf of the National Association of Insurance Commissioners

Chair Waters and Kanjorski, Ranking Members Biggert and Pryce, and Members of the Subcommittees on Housing and Community Opportunity and Capital Markets, Insurance, and Government Sponsored Enterprises, thank you for the opportunity to testify on H.R. 3355, the Homeowners' Defense Act of 2007. My name is J. P. Schmidt. I am the Insurance Commissioner for the state of Hawaii and I am here today on behalf of the National Association of Insurance Commissioners.

Last month, in the span of just 24 hours, my state was hit with a magnitude 5.4 earthquake while we watched Hurricane Flossie, a category four hurricane, head straight for the Isles. At the same time, an earthquake in Peru generated a tsunami warning, a lava flow from Kilauea Volcano began winding its way toward old Hilo Town, and we were midway through a week long brush fire burning thousands of acres on the Waianae Coast. Fortunately, the recent earthquake and the weakening hurricane were relatively modest in terms of insured losses, the tsunami didn't develop, and the fire was kept from buildings and residences, but it is safe to say that Hawaii knows something about living with and managing the threat of natural disasters. We're still keeping an eye on the lava flow.

Natural disasters take a heavy economic and emotional toll on Americans across the country each year. The economic impact of natural disasters does not recognize state

boundaries and may affect several states or even the economy of the nation as a whole. States in harm's way continue to consider and implement solutions to managing the varying threats they face, and several proposals have been introduced in Congress in recent years to address the issue. Representatives Klein and Mahoney have put forward a bill that appears to build on those efforts, so we commend them for their leadership in addressing the issue, and for recognizing the important role states play in managing the threat of natural disasters.

Background

The availability of insurance is impacted by the perceived risk and historical experience of a particular region. Simply put, insurers have an expectation based on risk modeling, application of actuarial judgment and evaluation of past loss experience regarding the type, scope, and likelihood of experiencing insured losses based on the risks they will face in a given area. Insurers use this information to price their products. When there is an event that falls outside of the expected spectrum of historical risks in terms of severity and likelihood (such as Hurricane Katrina) or frequency (such as the four consecutive hurricanes that pummeled Florida in 2004), insurers recalculate their expectations and typically respond by: 1) making insurance products less available, 2) introducing coverage limitations, and/or 3) raising prices. For example, following the devastation of Hurricane Andrew in 1992, the availability of insurance in Florida became a serious concern as insurers began to question their exposure in a market with volatility they did not and could not fully anticipate. In essence, they could not control their exposure to risk and responded by limiting availability. The same dynamic exists today, but the

reductions in availability have spilled over into states that have not recently suffered a significant loss.

The current system of insurance is very good at handling the "normal" disasters ranging from car accidents, storms, and even some hurricanes, where the frequency of events has resulted in collection, compilation and analysis of data that allows for more accurate predictions of future losses, and the severity is such that the private market can cover the risk. However, there is the potential for natural disasters at such a scale that the private market cannot or will not be able to reasonably insure them, or insure them at a price that homeowners are willing to pay without opting out of the coverage. Through their own actions of withdrawing or reducing coverage in markets susceptible to such threats, insurers would seem to agree. In catastrophe prone areas around the country, there is a widening gap between what insurers feel they can reasonably charge to cover certain risks and what homeowners can reasonably afford to pay. This gap leads to a problem of underinsured or uninsured property and demands that local, state, and federal governments consider ways to bridge that gap. The fundamental question then becomes what is the appropriate role of government in managing and insuring for large natural disasters?

State Initiatives

States have employed a number of initiatives to aid in the response to natural catastrophes and to manage the availability and affordability of insurance prior to an event. In those situations when private insurance markets refuse to provide coverage for a particular risk

in a particular area, the states have filled the gap through a variety of tools. One tool some coastal states have used is a residual market mechanism, or "wind pool." The wind pools are state-run "insurers-of-last-resort" that provide wind coverage for customers the private market will not insure. If not for these wind pools, the financial and social impact of the 2004 and 2005 storm season would have been far worse. Wind pools typically run as non-profit entities and most set their rates above the private market so as to not compete with private insurers. Following Hurricanes Katrina and Rita, these pools grew dramatically as private insurers withdrew from the coastal market. As with private insurers, wind pools typically purchase reinsurance and have found similar problems with rising reinsurance costs as more and more policyholders at the highest level of risk are entering the wind pool programs.

Some states have residual market mechanisms know as FAIR, or "Fair Access to Insurance Requirements" Plans. Most FAIR plans were created in the 1960s when insurers struggled to manage the threat of rioting and civil unrest and allowed states to obtain federal reinsurance money if they established property insurance pools of last resort to make homeowner and business policies available to those insurers considered living in "high risk" areas. These residual market mechanisms now operate in 30 jurisdictions (including the District of Columbia and Puerto Rico) as insurers of last resort providing property insurance to those persons that the insurance industry decides not to cover.

Another tool used by states like Florida and California to fill insurance availability gaps is a state catastrophe fund. Florida's fund is a reinsurance mechanism that backs up private insurers, while the California Earthquake Authority functions as a direct writer of earthquake insurance. The Florida Hurricane Catastrophe Fund provides billions of dollars of reinsurance capacity for insurers at a lower cost than what is available in the private market (due to its tax-exempt status, low administrative costs, and lack of a profit or risk-load) in an attempt to mitigate some of the catastrophic exposure insurers face in that state.

In the early 1990s when insurance providers dropped wind coverage from their homeowner's policies, Hawaii responded by creating the Hawaii Hurricane Relief Fund (HHRF) to provide standard windstorm coverage for hurricane force winds. Payments beyond the reserve amount were assessed on existing casualty policies on all property and casualty premiums. This approach fixed the risk of participating insurers by the aggregate capital limits of the plan.

The NAIC has tracked and monitored State initiatives in response to catastrophic events and has conducted extensive research and analysis on how to manage and insure for losses stemming from large natural disasters.

NAIC Guiding Principles and H.R. 3355

In 1999, the NAIC adopted eighteen "Guiding Principles" to consider when evaluating federal catastrophe insurance legislative proposals. It is with these principles in mind that the NAIC looked at H.R. 3355, the Homeowners' Defense Act.

1. Legislation should recognize the important role played by the states in insurance regulation with respect to such areas as licensing insurers, solvency surveillance, approving rates and forms, licensing agents, assisting consumers during the claim settlement process and performing market conduct examinations.

   The Homeowners' Defense Act does not unnecessarily impede any of these state regulatory functions.

2. There should be a reasonable coordination and structuring of state and federal regulatory responsibilities with respect to a federal disaster insurance program that achieves the objectives of the program without unnecessarily compromising or preempting state regulatory authority and consumer protection. Necessary preemption of or limits on state regulatory authority should be compensated by requisite federal oversight. There also should be an appropriate balance of different private and public interests in the governance of and regulatory oversight over the program.

   The Homeowners' Defense Act provides for reasonable coordination and allows the Secretary of the Treasury to promulgate regulations needed to work with states.

3. Legislation should recognize that many catastrophe exposures subject insurers to potential adverse selection as persons with less catastrophe risk are less likely to voluntarily purchase coverage, while those persons with greater risk are more likely to purchase coverage. If legislation were to create a government primary program, the program should encourage the inclusion of both low-risk and high-risk insureds to promote greater risk spreading in a way that does not subject individual risk-bearing entities to adverse selection.

   The Homeowners' Defense Act generally does not address adverse selection. It provides a mechanism for all risk transfers assumed by qualified state reinsurance programs.

4. Legislation should promote or encourage that coverage is available to any property that meets reasonable standards of insurability.

   The Homeowners' Defense Act does not address this issue directly. It encourages the availability of coverage without addressing standards of insurability. It is possible that the Secretary of the Treasury would include appropriate land use and mitigation standards in regulations that it might publish.

5. Legislation should supplement but not replace other private and public insurance mechanisms where those mechanisms can provide coverage more efficiently.

   The Homeowners' Defense Act meets with this principle as it does not attempt to replace other mechanisms that are willing and able to offer coverage. It simply makes coverage available in areas where the private market has shown little interest in providing coverage.

6. Rates for the catastrophe peril should be actuarially sound and should consider all reasonable factors that can be feasibly measured and supported by theoretical and empirical analysis.

   The Homeowners' Defense Act does not address primary prices or attempt to regulate them in any way. It provides a federal backstop and a mechanism for cataloging risk and enabling more efficient risk transfers.

7. State residual market mechanisms and other pooling mechanisms for property insurance should be allowed to participate in the entity established by legislation to provide catastrophe insurance, in such a way as to not create incentives for business to be placed in the residual market.

   The Homeowners' Defense Act meets this principle. It encourages the participation of state residual market and catastrophe funds in the consortium and makes liquidity and catastrophic loans available to them.

8. If a program includes provision of primary property insurance for catastrophe perils, voluntary market insurers should exclude coverage for the catastrophe perils from standard property policies and provide all catastrophe coverage through the program mechanism.

   The Homeowners' Defense Act does not provide primary insurance.

9. Legislation should encourage individuals to participate in the program or run the risk of losing access to federal disaster insurance.

   The Homeowners' Defense Act is silent on access to federal disaster assistance.

10. If legislation designates certain states as "disaster prone" and makes provisions for those states, it should also address what happens if a disaster strikes in states not specified as "disaster prone."

    The Homeowners' Defense Act clearly defines what types of programs are eligible to participate.

11. For disasters that are seasonal in nature, any legislation creating primary coverage should encourage policyholders to maintain coverage throughout the year to stabilize premium flows and avoid adverse selection in terms of consumer decisions with respect to starting and ending coverage.

    The Homeowners' Defense Act does not address this issue as it does not provide primary coverage.

12. Jurisdiction over claim settlement practices should remain with the states.

    The Homeowners' Defense Act allows states to retain jurisdiction over claim settlement practices.

13. Tax law changes should be encouraged to avoid penalties on and encourage the accumulation of reserves for catastrophe losses.

    The Homeowners' Defense Act does not address tax-deferred catastrophe reserves for insurers.

14. Legislation should encourage loss reduction and hazard mitigation efforts.

    The Homeowners' Defense Act mentions in its statement of purposes that encouraging mitigation and prevention for catastrophes is one of the purposes of the Act. Details of how that is to occur are left to the Secretary of the Treasury through rulemaking authority.

15. Legislation should encourage the strengthening and enforcement of building codes to reduce loss.

    The Homeowners' Defense Act mentions mitigation, however, it does not discuss building codes specifically.

16. Legislation should not burden states with additional responsibilities without funding the mandated activities.

    The Homeowners' Defense Act does not burden the states with additional responsibilities. It establishes a state-federal partnership through the consortium.

17. There should be coverage protection within reasonable limits for personal property policyholders in the event of the insolvency of the program or its participants.

    The main purpose of the Homeowners' Defense Act is to enable efficient risk transfers and to make liquidity and catastrophic loans available to qualified programs when catastrophic events occur. This is intended to make sure that the state programs do not fail.

18. Federal legislation should encourage the geographic spreading of risk.

The Homeowners' Defense Act enables the more efficient geographic spreading of risk through the consortium. One of its main purposes is to make it easier to mix and match risk so that the market can assume risk that is diversified by both geography and by peril. This reduces the risk load portion of the cost of the risk transfer and the volatility of the resulting capital markets products.

The NAIC is encouraged that the Homeowners' Defense Act meets many NAIC guiding principles. The legislation clearly recognizes the states' important role in insurance regulation and encourages states, but does not mandate them, to participate in the consortium and liquidity loan programs and creates a state-federal partnership approach to attracting private capital to the insurance market to enhance availability. The success and efficacy of the legislation depends to a degree on how it is implemented, the perceived value for various states, and the interest in the private insurance and securities markets in participating. These considerations are difficult to predict, but we look forward to working with Congress to arrive at a viable solution to the natural catastrophe threat.

<u>Title I: National Catastrophe Risk Consortium</u>

Title I of the bill leverages state residual markets and state catastrophe funds by allowing participants to transfer catastrophe risk via the non-profit "Risk Consortium" to the private markets. The NAIC sees this as a possible mechanism to help lower potential losses to state catastrophe funds by extending them to the capital markets which have far greater capacity. The capital and surplus of the residential and commercial property insurance market is approaching $500 billion, while the global securities market is over

$50 trillion. The financial impact of a $50 billion storm would be a relatively small event if absorbed in the securities marketplace. This risk-transfer mechanism for states would create another avenue to cede risk, similar to the role of the reinsurance marketplace. A beneficial aspect of the consortium is the process of cataloging the various risks of its participants. If done in a transparent environment, providing access to such comprehensive data may provide greater knowledge and confidence for the investment community. This would seem to benefit sale of securities by both the consortium and insurers offering products tied to risk in participating states. With greater information about risk characteristics becoming available in a transparent environment, market participants would have greater confidence in projected outcomes and be in a better position to efficiently price the risk transfer.

While securitization is an important tool to spread risk, it is not a panacea. We see it as a potential vehicle that could augment but not replace the traditional reinsurance market. A key unknown that will determine the impact of this type of approach is the appetite of the investment community. The current catastrophe securitization market is relatively modest, but growing, so it is unclear what the appetite for this new state consortium product will be until we know the scope of the underlying risk and the details of the end product.

Title II: National Homeowners' Insurance Stabilization Program

Title II of the bill offers liquidity loans and catastrophe loans to state or regional reinsurance programs to help spread the timing risk associated with large natural

disasters. States without qualified reinsurance plans are also eligible for catastrophe loans. This additional access to capital that finances higher level catastrophic events could help reduce price volatility in the market that is reflected in homeowner premiums. It could also cause less of a drain on state and local resources leading to quicker rebuilding after a catastrophic event.

Currently, 32 states could participate in the loan program through a state fund or residual market mechanism. These include states with Fair Access to Insurance Plans (FAIR), Beach and Windstorm Plans, state-run insurance companies and state-sponsored catastrophe funds or pools. Two states, Florida and Louisiana, have state-run insurance companies, - the Florida Citizens Property Insurance Company and the Louisiana Citizens Property Insurance Company – and two, Florida and California, have state-sponsored catastrophe funds – the Florida Hurricane Catastrophe Fund and the California Earthquake Authority.

The impact of a liquidity loan could benefit an area best if it supports all market participants in that area. For example, the Florida Cat Fund makes available reinsurance to all willing participants, and therefore its benefits can be realized by all consumers. For that reason, a reinsurance-type facility would be a better structure for managing liquidity loans than a residual market wind pool. A wind pool is a direct writer of insurance and does not have the ability to provide a backstop to insurers in a region. For all consumers to benefit, states would either need to create a separate reinsurance entity, or restructure the residual market entity to take on this additional role. State reinsurance funds could be

structured to allow a robust private insurance and reinsurance mechanism up to some level where losses become catastrophic and rare. Having a state entity provide coverage beyond that point would give insurers some parameters of potential exposure in which to operate. This certainty would be reflected in the pricing of their products. Backing those state entities with a federal guaranty would, in turn, give those state entities the ability to spread their absorbed risk over time. Such an approach leaves the private market as the first line of defense for the vast majority of insured events but recognizes that state and federal government involvement becomes necessary for truly catastrophic events.

The insurance and reinsurance markets have a significant amount of capacity, and access to that capacity for events that are small yet frequent is generally affordable. But for those that live in areas where events can be infrequent yet catastrophic, access to insurance capacity is either unavailable or unaffordable. This is the dilemma that regulators and legislators must face together. We commend Representatives Klein and Mahoney for their approach to tackling this challenging dynamic, and we commend the Subcommittees for today's hearing on this important issue. Thank you for the opportunity to offer my perspective, and I would be happy to answer any questions you might have.

Statement of Dr. John S. Seo

Co-founder & Managing Member
Fermat Capital Management, LLC

Testimony Before
United States House of Representatives
Subcommittee on Housing and Community Opportunity
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

September 6, 2007

Hearing on H.R. 3355, the Homeowners Defense Act of 2007

I thank the Subcommittee on Housing and Community Opportunity and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises for inviting me to testify at this hearing on the catastrophe bond and risk-linked securities market, which I will simply refer to as the cat bond market.

My name is John Seo. I am co-founder and managing member along with my brother, Nelson Seo, of Fermat Capital Management, LLC. Fermat Capital was formed in 2001 and manages 2 billion dollars in cat bond investments.

The cat bond market was invented by Wall Street in the mid-to-late 1990's to get a piece of the tremendous profits that were being made in the traditional reinsurance markets in the wake of Hurricane Andrew and the Northridge Earthquake. I believe that because greed (and not portfolio benefit or capital relief) was such an overwhelming motivation in the early years of cat bonds, from 1997 to 2000 the people that needed to work together in the cat bond market ended up rubbing each other the wrong way. The Wall Street and insurance culture clash did not help either. Dozens of deals still got done, but each cat bond was like a miracle child, while being a technical marvel as well.

Around the year 2000, it was apparent that cat bonds were not going to live up to all the early hype, so a lot of the abrasive personalities in the business just moved on, and those who were still interested in building the cat bond market were able to work in peace. By the time Hurricane Katrina struck our Gulf Coast, the cat bond market had just reached something close to 5 billion in liquid cat bonds outstanding and was actually looking pretty good. (Note: the larger cat bond market, depending on how you count it, is 2 to 3 times bigger than the liquid market.)

Earlier progress aside, Hurricane Katrina changed everything, accelerating growth in the cat bond market to the point that, in the course of 2 years, the liquid cat bond market will have almost tripled in size to about 14 billion in bonds outstanding by the end of this year. A good 6 billion of those bonds will cover U.S. hurricane risk alone. Looking

forward, even with things cooling down a bit, we might still reasonably forecast a 50 billion dollar liquid cat bond market in 5 years.

There are many questions that one might ask at this point, but I will ask and answer only two of them:

First: What will drive cat bond supply? In the long term, what will drive cat bond supply is the cat bond market's version of Moore's Law. As you know, Moore's Law, which says that the number of transistors we can put onto a square inch of silicon doubles every 2 years, is credited with driving the growth of digital technology. The equivalent of Moore's Law for cat bonds is that the amount of property value we put onto every square mile in key U.S. and overseas earthquake and hurricane zones is doubling every 10 years. On the other hand, global reinsurance and insurance capital available to earthquakes and hurricanes does not double every 10 years—it probably increases something like 35 percent every 10 years. This fundamental shortfall between risk and capital growth is what will drive cat bond supply.

Second and last: What will drive cat bond demand? In the long term, what will drive cat bond demand is buying interest of pension funds and other similar or related institutional investors. Here are the numbers: pension funds worldwide have about 15 trillion dollars in assets. If pension funds want to put 1 percent of their assets into cat bonds (and that is shaping up to be the case), pension funds alone will end up investing 150 billion dollars in cat bonds. Pension funds can be gigantic, committed, long-term investors with realistic return goals, and, as a whole, they generally go by a particular Rule of 10's: to be taken seriously, any new market must: (1) Be in existence for at least 10 years, and (2) Grow past 10 billion dollars in size. Both of these things occurred in the cat bond market just this year, so policymakers might consider that the next 10 year's of cat bond market growth is likely to be supported by a single class of investors so large that even a 150 billion dollar insurance industry loss would cost them no more than 1 percent of their assets.

Thank you for your attention.

Independent Insurance Agents & Brokers of America, Inc.

**STATEMENT OF STEVEN J. SPIRO
ON BEHALF OF THE
INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA**

BEFORE THE

SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY AND SUBCOMMITTEE ON CAPITAL MARKETS, GOVERNMENT SPONSORED ENTERPRISES, AND INSURANCE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

September 6, 2007

Good afternoon Chairwoman Waters, Chairman Kanjorski, Ranking Member Biggert, Ranking Member Pryce and Members of the Committee. My name is Steven J. Spiro, CLU, ChFC, and I am pleased to be here today on behalf of the Independent Insurance Agents & Brokers of America (IIABA) to provide my association's perspective on efforts to reform how our nation insures against natural disasters. I am currently serving on the Government Affairs Committee of IIABA. I am also President of Spiro Risk Management, Inc., an independent insurance agency based in Valley Stream, NY which offers a broad array of insurance products to consumers and commercial clients in New York and approximately 30 other states.

IIABA is the nation's oldest and largest trade association of independent insurance agents and brokers, and we represent a nationwide network of more than 300,000 agents,

brokers, and employees. IIABA represents independent insurance agents and brokers who present consumers with a choice of policy options from a variety of different insurance companies. These small, medium, and large businesses offer all lines of insurance – property, casualty, life, health, employee benefit plans, and retirement products. It is from this unique vantage point that we understand the capabilities and challenges of the insurance market when it comes to insuring against catastrophic risks.

Background

Whether it is the possibility of earthquakes on the West Coast or along the New Madrid Fault or threats posed by hurricanes, just about every corner of the United States is subject to the effects of a devastating natural catastrophe. Just when Hurricane Andrew was starting to pass from our collective memory, Hurricane Katrina and the other storms of 2004 and 2005 reminded us, with devastating effect, of the deadly and sweeping impact that such catastrophes can impose on a society and economy. Although Katrina was an unprecedented event in many ways, the reality is that similar and even more powerful storms will inevitably strike the Atlantic and Gulf Coasts.

This unfortunate and regrettable certainty has created what amounts to a property insurance crisis in some parts of the country, but it also affects nearly every other coastal state to some degree. I have seen the effects firsthand.

By many measures, the insurance industry is a highly competitive one. There are multiple distribution channels, and purchasers in most markets can typically buy coverage from many different direct, captive, or independent agent options. Coastal regions of this country, however, do not have a vibrant or competitive homeowners' insurance marketplace today, and the commercial marketplace is increasingly facing the same challenges. For example, a number of major companies are no longer writing new homeowners' policies on Long Island, New York. Meanwhile, the commercial marketplace is now seeing insurance policies with separate windstorm deductibles as well as new limitations on business interruption coverage, with one company recently instituting a $500,000 limit on such coverage.

Like independent agencies nationwide, I represent and have the ability to provide my customers with insurance policies from many different companies. My agency sells a wide variety of insurance policies – from personal lines products such as auto and homeowners insurance to commercial lines insurance for businesses, and from life insurance to employee benefits – and, overall, we represent over 10 different companies.

Unfortunately, there are only a handful of insurers that are able or willing to provide catastrophe coverage in my community, and much of the Eastern seaboard faces similar difficulties. Consumers today find it incredibly difficult and in many cases impossible to secure affordable insurance coverage for their homes and businesses. As an independent agent, I cannot serve my clients if I do not have insurance company partners willing to provide coverage, and that is the challenge I face today.

In order to fully appreciate this crisis, I believe it can be helpful to look at a few of the many root causes. Consider the following:

- Seven of the nine costliest hurricanes in our nation's history occurred in 2004 and 2005, and experts expect this trend to continue. While we may have received a slight respite in 2006, respected meteorologists believe the frequency and intensity of hurricanes will continue to grow over the next 15 to 20 years.

- Just three weeks ago, Hurricane Dean, the first Category 5 storm to make landfall in the Atlantic Basin since Hurricane Andrew, provided a vivid reminder of what we are confronting. In its revised 2007 hurricane outlook (issued August 9), the National Oceanic and Atmospheric Administration (NOAA) predicted an above-normal season with a likely range of 13-16 named storms, 7-9 hurricanes, 3-5 of which will be major.

- There has been unprecedented population growth and significant development in coastal and disaster-prone areas in recent decades, and total property exposures have increased dramatically. The explosive growth and concentration in these areas increases Total Insured Values and Probable Maximum Loss from hurricanes, and results in larger human and economic losses when disaster strikes. According to AIR Worldwide, a leading risk modeling and technology firm, in 2004 the value of insured coastal properties in the 18 East Coast and Gulf states exposed to hurricanes totaled $6.9 trillion, or 16 percent of insurers' total exposure to loss in the United States. Not unlike other disaster-prone areas, AIR also estimates that property values in coastal areas of the United States have doubled over the last decade.

- Wall Street firms and agencies that rate insurer financial stability have changed their evaluations and more heavily consider the effects of Probable Maximum Loss and Total Insured Value on the financial strength of insurers. This reality is forcing insurers to reduce catastrophe exposures.

- Insurance companies purchase reinsurance to help manage their catastrophe exposures, and reinsurers have increased the premiums they charge insurers to cover catastrophe claims. However, the prices and terms of property insurance offered by insurers remain highly regulated, and insurance companies are unable to pass along those costs. This reality has further decreased the amount of catastrophe risk insurers seem to be willing to accept.

National Problem

I would particularly like to stress that this issue is not simply a Gulf Coast problem – it is a national problem. Nearly all Americans live in an area that is susceptible to natural disasters, and, without a comprehensive national catastrophe plan, taxpayers across the

country will continue to bear the financial burden of helping to rebuild communities hit by catastrophic events.

Hurricanes may be the most well-known and regularly occurring disasters, but they are only one of the many catastrophic risks our nation faces. According to the Insurance Information Institute, tornadoes, earthquakes, mudslides, blizzards, and other catastrophes combined have accounted for over one-half of the U.S. catastrophe losses in the last 20 years. Earthquakes are a particularly powerful threat. Neither the Loma Prieta nor Northridge Earthquakes could be categorized as the "Big One," yet these events of the last twenty years combined to cause more than 120 deaths and 10,000 injuries and resulted in over $50 billion in property damage. In the Mississippi Valley, the often-overlooked New Madrid Fault was the scene of several magnitude 8 earthquakes nearly 200 years ago, and scientists estimate that there is a 90% probability that a magnitude 6 to 7 earthquake (or greater) will indeed occur within the next 50 years. If similar disasters occurred in California or in the Midwest today, they could easily result in well over $100 billion in losses and countless casualties.

The same marketplace challenges that have affected coastal areas are now beginning to occur in earthquake and other catastrophe-prone areas. Along the New Madrid Fault line, for example, insurers are beginning to react to the exposures and risks they face. In recent weeks, both a large national and a regional company have announced their intentions to completely withdraw over time from the residential and commercial earthquake market in a multi-state region along the fault line. The regional company is the largest regional writer of homeowners' insurance coverage for independent agents in these earthquake areas, and as many as 70,000 customers could be affected by their decision alone. These latest developments are further evidence of the increasing national scope of this problem.

States across the country have admirably and proactively attempted to increase insurance capacity and decrease the risks posed by and the costs created by catastrophic events. State governments have attempted to stabilize insurance markets by implementing a variety of policy options – such as creating residual markets, catastrophe funds, and state-sponsored insurers and establishing building codes – but these efforts fail to adequately address massive natural disasters and leave our country unprepared for an especially severe hurricane or powerful earthquake. The plain truth is that some natural disasters will overwhelm the modest state-specific measures that have been implemented, and only a program that is national in scope can generate enough capacity to cover the increasingly devastating events that we have witnessed in recent years.

In order to effectively prepare for and insure against natural disasters, our country needs a national catastrophe plan, and such a program can only be established by Congress. Put simply, insuring against natural disasters is a national problem that requires a national solution. Despite our longstanding position that the insurance market is best served by limited federal involvement, we believe that a federal solution to the issue of natural catastrophe insurance is necessary to help provide capacity and fill a void that the private market cannot and will not service. However, it is important that the day-to-day

regulation of insurance remain at the state level, where state insurance departments are best equipped to serve the special needs of local consumers in local markets. As such, given the absence of affordable coverage and the exposure that both consumers and taxpayers face, we believe that there is a very limited and appropriate role for the federal government, and we are open to supporting proposals that increase insurance availability and affordability in catastrophe-prone areas.

IIABA is not alone in calling on Congress to act, and an increasing number of state and local officials are coming to the conclusion that a comprehensive national solution is necessary. In February of this year, the bipartisan Southern Governors Association adopted a resolution urging Congress to create a "reasonably priced national reinsurance program supported by actuarially sound premiums." More recently, the U.S. Conference of Mayors adopted a similar resolution supporting the establishment of a national disaster plan and financial backstop. Copies of both statements are included at the end of my written testimony.

IIABA is comprised of thousands of small businesses and as such, we have always preferred market-driven solutions to problems and are suspect of new government programs. In short, we do not adopt a position like this lightly. We do so only because we see no other available course of action to resolve this availability crisis.

IIABA Perspective on the Homeowners Defense Act of 2007

On behalf of IIABA, I first would like to thank Representatives Ron Klein and Tim Mahoney for their efforts to address this natural disaster crisis. IIABA is extremely grateful for your work on this issue and for the opportunity to share its views on what we feel is a matter of critical importance.

Our members approach the issue of natural disaster insurance from a very simple perspective: we are here to serve consumers' needs, whether it is helping them secure coverage to protect their families, their homes, and their businesses prior to an event, or assisting consumers after an event to ensure that claims are paid quickly and fully. As the intermediaries between consumers and their insurers, our members cannot and will not walk away from consumer needs as long as they demand coverage for these risks. We strongly believe our industry must come together with policymakers to find a common solution that will encourage participation in at-risk markets.

In short, we welcome all proposals and support any and all <u>reasonable</u> ideas and plans that lead us to a healthy and competitive insurance marketplace in which consumers have choices and companies are vying for their business.

While IIABA is not yet ready to formally endorse the Homeowners Defense Act of 2007 at this time, we do believe it provides a number of provisions that could have a positive impact on the availability and affordability of natural disaster insurance. There are, however, important questions associated with these provisions that must be answered.

The creation of a National Catastrophe Risk Consortium would create an organization that states can voluntarily join for the purposes of transferring catastrophe risk. The risk transfer would be achieved through the issuance of risk-linked securities or through reinsurance contracts. The goal of the consortium seems to be to offer both states and private market participants an opportunity to benefit from a pooling of catastrophic risk diversified by type of peril and geographic region.

If a number of states elect to participate in this Consortium, and if the private market determines that the risk-linked securities are an attractive investment, there is the possibility that the Consortium could offer reinsurance contracts to private participants at a lower cost than is currently available. However, IIABA does have concerns that some states that may not consider themselves to be high-risk may decline to participate in the Consortium, which would diminish the diversity of the risk-linked securities and negatively impact their value to potential buyers.

The creation of a National Homeowners' Insurance Stabilization Program, meanwhile, would potentially provide for a mechanism for liquidity loans and catastrophic loans for state and regional reinsurance programs, which could provide for a level of stability for such programs that is absent at this time. The loans would come in three distinct categories, Liquidity Loans, Catastrophic Loans, and Catastrophic Loans to States without Qualified Reinsurance Programs. Perhaps most encouraging about this proposal is that it seems to offer an incentive for more states to adopt their own reinsurance CAT programs in order to be considered "qualified programs," which states would have to have in order to receive the catastrophic loans after an initial 5 year transition period. However, it may be useful for the Committee to consider adding increased incentives for the speedy creation of state CAT qualified programs, as currently the only incentive seems to be a lower interest rate on the catastrophic loan. IIABA also feels that assistance from the federal government should be limited, if at all possible, to reinsurance to help the private market participants and not to direct state insurers of last resort. We encourage this Committee to make sure that this provision achieves that objective. Finally, while the provision requires "qualified" states to comply with mitigation and building code standards established by the Secretary of the Treasury, we believe that proper mitigation and building code standards are a key piece of solving this crisis and that the Committee may want to consider providing more direction in this area.

In short, IIABA believes that the Homeowners' Defense Act of 2007 deserves serious consideration and we are hopeful that, should the issues mentioned above be resolved, these proposals could be a part of a comprehensive solution to the problem of natural catastrophe insurance. Of course, the key to the success of any solution is how the private market will react and whether it will result in increased coverage.

Other Solutions

The strength of the Homeowners' Defense Act of 2007 lies in its attempt to have a plan in place to encourage greater availability of reinsurance for the private markets (through the Consortium) <u>before</u> a storm hits as well as its attempt to have a line of stability

available to state catastrophe reinsurance funds in the event of liquidity problems after a catastrophic disaster. These goals are consistent with the Big "I's" long-standing belief that the best solution is for a program to be in place before the events happen – to have a clear, well-structured mechanism that encourages the private sector to handle as much of the risk as possible, and only trigger federal involvement as a last resort upon private marketplace failure. We believe that it is important to have such a structure in place to protect both consumers and taxpayers living in all areas across the country – especially when history has proven that more tax dollars are going to be spent on disaster assistance without such a structure to encourage the private sector to take on additional risk.

It is with these sentiments that we also applaud other legislative proposals pending in Congress. Specifically, we support H.R. 330, the Homeowners' Insurance Availability Act, sponsored by Rep. Ginny Brown-Waite (R-FL). This legislation would allow private insurers to purchase, at auction, reinsurance contracts directly from the U.S. Treasury to cover natural disasters that are equal to or greater than a one-in-100-year event. We believe this is a strong proposal because it will encourage more companies to enter at-risk markets, thus increasing availability and market stability, while limiting federal involvement to only the most devastating catastrophes.

IIABA is also looking beyond federal reinsurance proposals to other possible solutions, and in that vein we are encouraged by the introduction of H.R. 164, the Policyholder Disaster Protection Act, introduced by Rep. Bobby Jindal (R-LA). This bill would permit insurers to create tax-free reserve funds for natural disaster claims. We support the goal of this legislation, which is to build up insurance capacity in at-risk markets.

Congressional Attention Is Needed

Achieving a consensus within the insurance market for a solution to this growing problem has proven elusive, which has complicated public and private efforts to address this issue. However, Members such as Representatives Klein and Mahoney have made a concerted and responsible effort to achieve the difficult to reach consensus, and we applaud them for their efforts.

We thank this Committee and the Members of Congress mentioned above for their leadership on these issues, and we look forward to continuing to work with this Committee, Representatives Klein and Mahoney, and other leaders on this issue such as Representatives Brown-Waite and Jindal on the Homeowners' Defense Act of 2007 and other legislative proposals.

In conclusion, we commend you for convening today's hearing, and we hope that the Committee will continue its thorough examination of legislative solutions for the catastrophe insurance availability crisis.

The Big "I" is committed to an open dialogue with all interested parties in the public and private sectors to address these important issues that consumers face. We stand ready to assist your efforts in any way we can.

SOUTHERN
GOVERNORS' ASSOCIATION

RESOLUTION

Expressing the sense of the Southern Governors' Association that Congress should adopt legislation to create a national reinsurance plan in order to provide for the availability of reasonably priced property and casualty insurance from private markets to homeowners throughout the nation.

Whereas, every state is vulnerable to natural disasters including hurricanes, tornadoes, flooding, earthquakes, blizzards, crop loss and wildfires;

Whereas, there is an increase in the incidence of major catastrophes and their increasingly costly nature;

Whereas, there have been significant insurance and reinsurance shortages, resulting in dramatic rate increases for consumers and businesses, and the unavailability of catastrophe insurance;

Whereas, Hurricanes Katrina, Rita, and Wilma, which struck the United States in 2005, caused over $200 billion in total economic losses, including insured and uninsured losses;

Whereas, the United States federal government has provided and will continue to provide billions of dollars and resources to help our nation recover from catastrophes, including hurricanes, tornadoes, earthquakes, blizzards and other disasters, at huge costs to American taxpayers;

Whereas, the United States federal government has a critical interest in ensuring appropriate and fiscally responsible risk management and pre-planning for catastrophes through measures such as mitigation and improved building codes;

Whereas, no action has been taken on the multiple proposals that have been introduced in the United States Congress over the past decade to address catastrophic risk insurance, including the creation of a national catastrophic reinsurance fund and the revision of the Federal tax code to allow insurers to use tax-deferred catastrophe funds;

Now, therefore, be it resolved,

That it is the sense of the Southern Governors' Association that:

The United States Congress should adopt legislation to create a reasonably priced national reinsurance program supported by actuarially sound premiums to provide relief to American homeowners and lower insurance premiums.

Time limited (effective Winter Meeting 2007 through Winter Business Meeting 2009)

HALL OF THE STATES 444 NORTH CAPITOL STREET, NW SUITE 200 WASHINGTON, DC 20001
202/624-5897 FAX 202-624-7797 WWW.SOUTHERNGOVERNORS.ORG

Celebrating 75 Years

CREATING A COMPREHENSIVE INTEGRATED NATIONAL CATASTROPHE FUND

Resolution Adopted June 2007

WHEREAS, every U.S. city plays a vital front line role in preparing and protecting their residents from the ravages of natural catastrophic events;

WHEREAS, every state is vulnerable to natural catastrophes including hurricanes, tornadoes, floods, earthquakes, blizzards, and wildfires;

WHEREAS, there is an increase in the incidence of major natural catastrophes and their increasingly costly nature;

WHEREAS, there have been significant contraction in insurance availability and significant increase in costs for consumers;

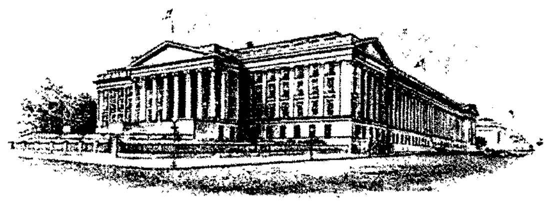
WHEREAS, Hurricanes Katrina, Rita, and Wilma, which struck the United States in 2005, caused well over $200 billion in total economic losses, including both insured and uninsured losses;

WHEREAS, the United States federal government has provided and will continue to provide billions of after-event appropriated dollars and resources to help our nation recover from catastrophes, including hurricanes, tornadoes, earthquakes, blizzards and other disasters, at huge cost to all American taxpayers;

WHEREAS, the United States federal government has a critical interest in ensuring appropriate and fiscally responsible risk management and pre-planning for catastrophes through measures such as loss prevention and mitigation, improved public education and effective emergency management services;

WHEREAS, the U.S. Congress has had under consideration, but taken no action on multiple proposals over the past decade to address natural catastrophic risk insurance, including the creation of a national catastrophe financial backstop program and revision of the Federal tax code to allow insurers to build tax-deferred catastrophe funds;

NOW, THEREFORE, BE IT RESOLVED, That The United States Conference of Mayors strongly urges Congress to adopt legislation creating a comprehensive, integrated national catastrophe plan (which includes the participation of states)to better prepare and protect American homeowners from inevitable, large-scale natural catastrophes that includes a financial backstop supported by actuarially sound premiums to improve the availability of reasonably priced property and casualty insurance from private markets to homeowners throughout the nation.



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 2p.m. (EDT), September 6, 2007
CONTACT Eileen Gilligan, (202) 622-2960

TESTIMONY OF TREASURY ASSISTANT SECRETARY FOR ECONOMIC POLICY PHILLIP SWAGEL BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES SUBCOMMITTEES ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES; AND HOUSING AND COMMUNITY OPPORTUNITY

WASHINGTON, DC -- Good afternoon Chairman Kanjorski, Chairwoman Waters, Ranking Member Pryce, Ranking Member Biggert, and Members of the Subcommittees. The effects of Hurricanes Katrina, Rita, and Wilma are reminders of the destructive forces of nature. Insurance coverage against natural catastrophes cannot undo the toll of these events, but insurance can provide families and businesses with the ability to recover from their financial losses. Government actions that interfere with well-functioning private insurance markets can have unintended consequences that make it more difficult and costly for families and businesses to obtain coverage. Such actions can further detract from the long-term financial soundness of our government.

The Administration seeks to ensure that there is a stable and well-developed private market for natural hazard insurance and reinsurance. The Administration strongly opposes H.R. 3355 because its provisions are at odds with this goal.

The Private Insurance Market Provides Coverage for Natural Hazards
Private insurance markets for natural hazard insurance are active and effective. The experiences with catastrophes in 2004 and 2005 led insurers to increase their estimates of probable losses from future hurricanes. As a result, insurers obtained state regulatory approval and increased their premiums to cover future losses and enhance solvency. Certain coastal areas have experienced increases in rates. This can be difficult for homeowners, but this is fundamentally a reflection of the cost of risk, not a defect of the market. While certain coastal areas have seen reduced availability of private insurance as well, these shortages generally can be traced to state regulatory actions.

H.R. 3355: The Homeowners' Defense Act of 2007
H.R. 3355, the Homeowners' Defense Act of 2007, is intended to provide support and assistance to state-sponsored insurance and reinsurance programs. State-sponsored programs generally can be divided into two categories: (1) programs such as assigned risk pools or residual market facilities that provide coverage directly to homeowners who cannot obtain private coverage, and (2) state-run reinsurance programs that provide coverage for private insurers and state-run residual funds. Florida, for example, has both types of programs: the state-sponsored Citizens Property Insurance Corporation sells wind-loss property insurance and homeowners' insurance to homeowners, and the Hurricane

Catastrophe Fund, backed by the state's ability to cover future losses through taxation, provides reinsurance to private insurers at below-market rates. Florida is currently the only state with a reinsurance program.

H.R. 3355 provides two distinct mechanisms to help state-sponsored programs. The first is the creation of a federally chartered organization, the National Catastrophe Risk Consortium. The bill empowers the Consortium to issue risk-linked securities in the capital markets and enter into reinsurance contracts. The Consortium would facilitate the transfer of catastrophe risks insured by state-sponsored programs to private reinsurance markets and capital markets. The second proposed mechanism is the establishment of the National Homeowners' Insurance Stabilization Program at the Treasury Department. Through the Stabilization Program, the Treasury Department would provide medium- and long-term loans to state insurance programs at below-market rates.

The Consortium and the Stabilization Program Provide Subsidies

The functions of the Consortium could be accomplished without new legislation. State-sponsored programs are free to pool risks today and they have access to competitive, world-wide reinsurance and capital markets designed to pool risks globally. This can be done today with traditional reinsurance arrangements or through natural catastrophe bonds.

I understand that in designing the Consortium, the intent of the bill's sponsors may not have been to create a new subsidy; nevertheless, as written, the Consortium would provide one. The Consortium's federal charter would benefit state-sponsored programs in that the reinsurance contracts and financial instruments entered into or facilitated by the Consortium would be seen as carrying an implicit federal government guarantee. This implicit guarantee would distort prices for these instruments and result in subsidized coverage for the participating states. This would impose a hidden cost to all taxpayers.

The Stabilization Program would provide subsidies in a more straightforward manner. The Stabilization Program's title requires Treasury to extend 5- to 10-year "liquidity loans" and longer-term, post-disaster "catastrophe loans" at below-market rates to state-sponsored programs.

The ability to borrow at below-market rates would lower the cost of running a state-sponsored program and reduce the need for states to purchase private reinsurance and charge adequate rates in order to maintain capital reserves. This would lead the state-sponsored programs to further subsidize rates.

Subsidizing Insurance Would Displace Private Markets, Promote Riskier Behavior, Be Costly, and Be Unfair to Taxpayers

The subsidies provided by the Consortium and the Stabilization Program would encourage the creation of new state-sponsored programs and the expansion of existing state-sponsored programs to offer subsidized insurance and reinsurance. These subsidies would result in the displacement of private coverage, lead to costly inefficiencies, and retard innovation in the private sector. Lower insurance premiums would reduce economic incentives to mitigate risks and encourage individuals to take on inappropriate risks. This would also make taxpayers nationwide subsidize insurance rates in high-risk areas.

Rather than relying on the federal government, state programs should purchase private market reinsurance to cover their capital needs. Purchasing reinsurance from private markets would allow the states to take full advantage of the world-wide diversification of private markets and send the appropriate economic signals to mitigate risk and to discourage individuals from taking on inappropriate risk.

State-sponsored programs that lower insurance prices below the actuarially fair value encourage people to locate in high-risk areas. The experience of the National Flood Insurance Program (NFIP) illustrates this concern. The NFIP provides insurance to some older properties at below-market rates, including

some properties that have been damaged numerous times by floods. This encourages families to continue to live in vulnerable areas without sufficient mitigation. Subsidies for natural catastrophe insurance will encourage over-development in hurricane- and earthquake-prone areas, putting more people in harm's way.

The bill could result in large liabilities for the federal government, which might be expected to step in to support the operations of the contracts entered into or facilitated by the Consortium. In addition, there is a risk that the Stabilization Program would not receive full repayment of the loans with interest. The Stabilization Program reduces incentives for state reinsurance programs to be sufficiently capitalized—state programs will hold less capital because they have the federal line of credit. The burden of repaying those federal loans will fall on the state's citizens. This tax burden may lead the state to seek deferrals or reductions in its federal loans. With federal financing, it is more than likely that there will be significant pressures to forgive outstanding debt in the case of a huge catastrophe. The NFIP again illustrates this likelihood. In these cases, taxpayers nationwide would subsidize insurance rates in high-risk areas, which would be both costly and unfair.

Conclusion

Allowing private insurance and capital markets to fulfill their roles is the best way to maintain the economic sustainability of communities at greatest risk of natural catastrophes. Federal government interference in a functioning natural hazard insurance market would crowd out an active and effective private market, increase the incentive for people to locate in high-risk areas, result in potentially large federal liabilities, and be unfair to taxpayers. For these reasons, the Administration opposes H.R. 3355.

THE COMMONWEALTH OF MASSACHUSETTS
MASSACHUSETTS HOUSE OF REPRESENTATIVES
STATE HOUSE • BOSTON, MA 02133

MATTHEW C PATRICK
STATE REPRESENTATIVE
3RD BARNSTABLE DISTRICT
STATE HOUSE, ROOM 540
TEL (617) 722-2090
FAX. (617) 626-0263
DISTRICT OFFICE: (508) 540-6308
E-MAIL: REP MATTHEWPATRICK
@STATE.MA US

COMMITTEES :
TELECOMMUNICATIONS,
UTILITIES AND ENERGY
STATE ADMINISTRATION AND
REGULATORY OVERSIGHT
MUNICIPALITIES AND REGIONAL
GOVERNMENT

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RESPONSE TO QUESTIONS FROM THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY AND THE SUBCOMMITTEE ON CAPITAL MARKETS
By, Representative Matthew C. Patrick
September 4, 2007

1. *Is the insurance industry equipped to handle 100 and/or 250 – year natural catastrophic events? What portion of such an event could the primary insurance industry absorb compared to the reinsurance industry?*

I believe the insurance industry is equipped to handle a catastrophic event because they are acquiring reinsurance at a considerable expense and passing that added cost on to their customers. For example, in 2005 the Massachusetts FAIR Plan spent $17.5 million for $500 million worth of reinsurance. In 2006, they spent $43 million for $455 million in reinsurance and in 2007 the FAIR Plan spent $75 million for $979 million in reinsurance. The price of insurance in coastal areas in Massachusetts has gone up more than 150 percent in three years for many homeowners.

Several retail homeowners' insurance companies have left the coastal market citing the cost they must pay for reinsurance and the increase in projections by catastrophe models for hurricane damage. Reinsurance has increased due to the predictions of proprietary computer models as well as 2004 and 2005 hurricanes in the United States and other worldwide catastrophes.

I am not qualified to answer what portion a primary insurance company should pay in the event of a catastrophic event.

2. *How would the catastrophic loan product envisioned in Title II of the bill assist states, with or without catastrophe funds, in providing increased access to affordable homeowners' insurance to consumers?*

The Klein and Mahoney bill, HR 3355 will be very helpful to our efforts. HR3355 will provide us with a backup in the event of an extreme catastrophic event that depletes our reinsurance pool

before we have it fully funded which will be seven to ten years. It will also help us finance the fund by issuing bonds if the Commonwealth has trouble on its own.

We believe that the establishment of our state catastrophic fund, backed by the federal fund will result in a calming of the market because the insurance companies will be purchasing reinsurance from the Commonwealth at a lower cost than if bought through private reinsurers. The fund will continue to grow until there is a catastrophic event. Once the cost of reinsurance is stabilized, we believe that market forces will cause many companies who have left coastal areas to recommence writing business in these areas. Cape Cod and coastal Massachusetts are fundamentally desirable places to do business. Homes are well built and maintained, major storms are infrequent and people pay their premiums. HB 3355 will help us to help market forces to work!

3. *What role can the public sector play in partnering with the private sector in general and the insurance sector in particular to reduce the potential losses from future natural disasters and increasing the speed and efficiency of recovery from any large scale disaster?*

The public sector can do more to inhibit construction in flood plains and high wind velocity areas. This can be done by purchasing open space along the coast whenever possible. While a land acquisition of coastal areas may be expensive, the cost should be balanced with the economic and environmental impacts caused by a major storm.

Federal Flood insurance should be available only for one or at the most two events. After that it should be discontinued and the homeowners should be forced to buy insurance on their own or sell to the Federal coastal acquisition program.

Building codes could be toughened for new buildings near the coast but that should be done reasonably with attention to affordability. Massachusetts is currently recommending new codes for this purpose.

My home town of Falmouth, where I served as a Selectman for six years commissioned a blue ribbon panel to make recommendations on protecting our coast line from catastrophic events. This panel was made up of some of the foremost experts in coastal erosion in the world by virtue of the in town location of the Woods Hole Oceanographic Institute, the Marine Biological Laboratory, U.S.G.S and NOAA. Their extensive report could be summed up in three sentences, don't try to protect the coast with groins, shielding or any other device because they do more damage than good. They should be taken out whenever possible. The coastline is a dynamic system that cannot be controlled.

4. *In your experience, how are state residual insurance market entities (e.g., state FAIR plans and wind pools) functioning in your state and around the country?*

The Massachusetts FAIR plan is struggling to break even because of the high cost of reinsurance as mentioned earlier. Their costs passed on to consumers have increased dramatically and they have been called to fill a huge void left by the departure of the retail insurance companies.

Today, forty four percent or 57,527 homes on Cape Cod and the islands are now with Massachusetts FAIR Plan, the insurer of last resort. That's up from 5,614 in 2001 or better than a one thousand percent increase. The average FAIR Plan premium on the Cape and islands is now just over $1,739 up from about $700 in 2001. The FAIR Plan is no longer just the insurer of last resort for economically troubled areas. It has become the only option for many residents in coastal areas. The FAIR plan is increasing its rates to keep up with its costs of reinsurance. It has won a 25% increase from the insurance commissioner and has applied for a second 25% increase.

5. *Would state residual insurance market benefit from access to capital markets facilitated by the provisions of H.R. 3355?*

I believe they would if they are unable to find interest rates that are low enough to ensure a savings for homeowners, the FAIR Plan and private insurance companies.

6. *Would state residual insurance market entities benefit from access to liquidity and catastrophic loans as envisioned by H.R. 3355?*

Absolutely! It will provide the backup we need until the catastrophic fund proposed in the Massachusetts S 624. The Klein and Mahoney bill, HR 3355 will be very helpful to our efforts. HR3355 will provide us with a backup in the event of an extreme catastrophic event that depletes our reinsurance pool before we have it fully funded which will be seven to ten years. It will also help us finance the fund by issuing bonds if the Commonwealth has trouble on its own.

7. *Do you believe that your state or other states would take steps to avail themselves of the benefits available under HR 3355?*

The Cape Cod State Legislative Delegation has moved forcefully by endorsing Senator Robert O'Leary's Catastrophic Reinsurance Fund, S 624 and actively educating our colleagues. The bill will create a reinsurance pool for private insurance companies doing business in the Commonwealth and the FAIR Plan. By doing so we hope to maintain the private sector's role as the primary risk bearer and stabilize the rising cost of homeowner's insurance. We have gained the support of many of our south coast and south shore colleagues and HR 3355 will help us in our effort to pass the legislation. HR 3355 should take away the last objections heard from inland legislators to S 624.

NAIC
making progress . . . together

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

September 27, 2007

EXECUTIVE HEADQUARTERS
2301 McGee Street
Suite 800
Kansas City MO
64108-2662
VOICE 816-842-3600
FAX 816-783-8175

GOVERNMENT RELATIONS
Hall of the States
444 North Capitol St NW
Suite 701
Washington DC
20001-1509
VOICE 202-471-3990
FAX 202-471-3972

SECURITIES VALUATION OFFICE
48 Wall Street
6TH Floor
New York NY
10005-2906
VOICE 212-398-9000
FAX 212-382-4207

WORLD WIDE WEB
www.naic.org

The Honorable Judy Biggert
Ranking Member, Financial Institutions and Consumer Credit Subcommittee
1034 Longworth House Office Building
Washington, DC 20515

RE: State Reinsurance Funds

Dear Representative Biggert:

I appreciated the opportunity to testify on behalf of the National Association of Insurance Commissioners (NAIC) at the September 6, 2007 joint hearing of the Subcommittee on Housing and Community Opportunity and the Subcommittee on Capital Markets on "H.R. 3355, the Homeowners' Defense Act of 2007."

At the hearing you asked me for a more complete answer to your question regarding state reinsurance funds. Specifically, you asked how many states have reinsurance funds.

Section 301 of H.R. 3355 defines a "qualified reinsurance program" as one authorized by state law which "provides reinsurance or retrocessional coverage to underlying primary insurers or reinsurers for losses arising from all personal real property and homeowners lines of insurance," with certain conditions such as financial interest by the state, majority governance by public officials, and additional compliance and precertification requirements as mandated by the Secretary of the Treasury.

Under this definition, only one state—Florida— currently has a "qualified reinsurance program" for the homeowners market. The Florida Hurricane Catastrophe Fund is a "pure" reinsurance fund, that is, a state-run reinsurance mechanism that backs up private insurers to fill availability gaps in the event of a catastrophe. The Florida Hurricane Catastrophe Fund provides billions of dollars of reinsurance capacity for insurers at a lower cost than what is available in the private market (due to its tax-exempt status, low administrative costs and lack of a profit or risk-load) in an attempt to mitigate some of the catastrophic exposure insurers face in that state.

Section 202(g) of the bill would expand eligibility of states without qualified reinsurance programs for catastrophic loans, provided the loan is made to a state residual insurance market entity (or "wind pool"—which acts as an insurer of last resort providing property insurance coverage to those persons the insurance

industry decides not to cover) or to a state or regional reinsurance plan that is not a qualified reinsurance plan, if the loan is cosigned by a state public official with legal authority to do so and officers of the residual market entity or reinsurance plan. Under this expanded eligibility, an additional 32 states would be able to extend loans.

As noted in our testimony, the NAIC believes that a reinsurance-type facility could be a useful optional structure for managing liquidity loans as an alternative to a residual market wind pool, as it provides a backstop to all insurers (and therefore all insurance consumers) in a region. States would have the option to restructure their residual markets to take on this additional role, or states may see access to federal liquidity loans as an incentive to create a stand-alone reinsurance facility structured to the needs and exposure of insurers in that state.

If you have additional questions regarding our testimony or natural catastrophe insurance in general, please contact Avery Brown in the NAIC Washington office at (202) 471-3987, or abrown@naic.org.

Congratulations and best of luck to you in your new leadership role.

Sincerely,

J.P. Schmidt
Insurance Commissioner, State of Hawaii

cc: The Honorable Paul Kanjorski
The Honorable Maxine Waters
The Honorable Deborah Pryce

PROTECTING
AMERICA.org
PREPARING FOR AND PROTECTING AMERICA FROM CATASTROPHE

Admiral James M. Loy, National Co-Chair
Former Deputy Secretary, Department of Homeland Security
Commandant, U.S. Coast Guard (Retired)

James Lee Witt, National Co-Chair
Former Director, Federal Emergency Management Agency
Former Chief Executive Officer, International Code Council

STATEMENT OF

PROTECTINGAMERICA.ORG

**Before the
Committee on Financial Services
Subcommittee on Housing and Community Opportunity
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
U.S. House of Representatives**

H.R. 3355, The Homeowners Defense Act of 2007

September 6, 2007

1200 Nineteenth St. NW * Suite 400 * Washington, DC 20036 ■ 877-266-6660 (toll-free) ■ Fax 202-689-8599

ProtectingAmerica.org appreciates the opportunity to submit a statement for the record on H.R. 3355, the Homeowners Defense Act of 2007. ProtectingAmerica.org is a non-profit organization committed to finding better ways to prepare and protect American families from the devastation caused by natural catastrophes. Chaired by James Lee Witt, the former director of the Federal Emergency Management Agency and ADM. James M. Loy (USCG-Ret.), the former Deputy Secretary of the Department of Homeland Security and Commandant of the Coast Guard, our coalition's approximately 300 members include first responders like the American Red Cross, emergency management officials, insurers like State Farm and Allstate, municipalities, small businesses, Fortune 100 companies and thousands of private citizens. The membership is broad and diverse and includes members from across the nation.

H.R. 3355, the Homeowners Defense Act is an excellent starting point to address deficiencies in the current catastrophe management system in our country. Introduced on August 3, 2007 by Rep. Ron Klein (D-FL) and Rep. Tim Mahoney (D-FL), H.R. 3355's stated purpose is *"to ensure the availability and affordability of homeowners' insurance coverage for catastrophic events."* Our analysis below discusses the two major components of the legislation – the National Risk Consortium contained in Title 1 and National Homeowners' Insurance Stabilization Program which comprises Title II. Additionally, recommendations for broadening the scope of the bill's language to insure the successful achievement of its very important objectives are included.

Title I

Title I creates the National Catastrophe Risk Consortium ("NCRC") which serves as an *aggregator* of risk transfer needs, not as a provider of *additional* risk transfer capacity. What is needed to reduce costs and improve availability is a source of new capital, not merely an aggregation of existing sources. While there are theoretical marginal benefits to having a centralized purchaser of aggregated risk transfer needs, these benefits are at the margin only and may not substantially increase the availability or reduce the cost of such capacity.

Discussion and Recommendations:

A "perfect storm" involving (1) massive losses from storm events; (2) a fundamental reevaluation of risk by the major modeling agencies to account for a perceived period of more frequent and damaging storm activity; and (3) an increase in capital requirements by the major rating agencies, has resulted in a sustained capital shortage of affordable reinsurance. Aggregation does little to solve that problem.

Neither does the promise of issuing catastrophe-linked capital market securities ("cat bonds") address the issue of affordability nor availability. While cat bonds serve an important role in the provision of risk transfer, they have been a relatively minor player and are likely to remain so for a variety of reasons. To put it in perspective, 2006 was by far a record for cat bond issuance, with approximately $4.7 billion in issuance. However, the total U.S. bond market last year issued $6.1 <u>trillion</u> in securities. The cat bond market is very small, and does not materially alter the

capacity equation. In any event, that capital is only provided at costs so high as to do little to advance the cause of affordability for homeowners.

There is no certainty that investors will continue to buy cat bonds in the future, especially if there is another major catastrophe or series of catastrophes as many forecasts predict.

Recommendation:

To overcome these problems, one approach to consider would be to provide an additional source of more affordable reinsurance capacity to cover truly catastrophic events. Using a layered principle would make the most sense – homeowners' deductibles, absorption of the next layer of losses up to the policy limits by insurers, then private and State-sponsored reinsurers, and finally, a national fund to cover extreme events. This approach would help fill the capacity crunch created by the three events described above as it is unlikely that the private markets can or will fill this gap at *reasonable* prices. It may be possible to combine these approaches so that states have options to consider. We would be glad to assist the Committee in exploring that possibility.

Title II

The liquidity loan concept in H.R. 3355 is a good one, although as structured, it is likely to be under-utilized.

Here's why:

o Pricing of the liquidity loans is set at Treasuries + 300 basis points – a very expensive rate. This money would only be used as a short-term bridge by State funds until they could access the capital markets after an event for long-term capital needs. A more appropriate and comparable pricing structure would be LIBOR or some other standard liquidity rate. In Florida, for example, the State-sponsored residual insurer and reinsurer have accessed the markets for over $10 billion of liquidity, all at prices approximating LIBOR, which currently stands at 5.35%. As proposed currently in H.R.3355, Treasuries + 300 basis points for a 10-year comparison would equal 7.8%, which is very expensive for this kind of capacity, and would be unlikely to be utilized. Even as a "last resort" source of liquidity, this formula may simply be too expensive to be an attractive source of funds.

A catastrophe loan concept provides more cost-effective money for long-term capital needs to pay claims greater than the limit of state funds. It is counterintuitive that this type of risk capital would be priced lower than the short-term liquidity capital, but it is. As a concept, the liquidity loan does little to further either of the stated goals of

HR 3355, since it is not insurance, but simply borrowing.

The liquidity loan program would help communities better deal with the timing risk issues by providing a last-resort backstop loan source to ensure that claims are paid in a timely manner. However, as discussed above, the loans are very expensive and since they can only be accessed if states cannot find cheaper capital, these loans would only be used in extreme circumstances where traditional bank or capital markets access is limited or completely unavailable to the states. The primary benefit these loans would provide to state plans is planning certainty – it would not relieve them of their obligation to seek alternative sources of liquidity, since these high cost Title II loans would exert upward pressure on premiums.

Recommendation:

A pooled risk transfer model, by contrast, provides real insurance to State funds as it provides an underlying insurance program that if ever needed, could be amortized in premiums paid by the State funds rather than over the 10-year period catastrophic loan program contemplated by HR 3355. We would be glad to assist the Committee in enhancing the lending feature of this bill to help ensure that the bill achieves its objective more effectively and efficiently.

ProtectingAmerica.org would also like to comment briefly on several of the questions posed by the Committee regarding H.R. 3355:

Is the insurance industry equipped to handle large catastrophic events? What portion of such an event could the primary insurance industry absorb compared to the reinsurance industry?

The short answer is no. The industry generally does a very good job paying claims following large catastrophic events. However, dealing with stability and addressing volatility is another matter, and it is clear that the industry is not well equipped to continue to handle these events in an efficient and effective manner. Even at this moment, the primary insurance market has contracted significantly, and consumers in virtually all coastal areas are having difficulty getting or keeping high-quality insurance. Moreover, the price has risen dramatically for those who are able to get coverage. Meanwhile, the residual market has exploded in many places. These facts bear out that the current model does not serve consumers well. For very low frequency and very high severity events, the traditional insurance model breaks down and does not work efficiently. The current system is too volatile and expensive. There is a better way, and we would be glad to work with the committee to help craft the means to provide more stability and cost-savings for consumers within H.R. 3355.

How does timing risk play into the industry's ability to plan for large scale catastrophic events?

Timing risk is significant, and the federal government is in a unique position to address it.

The Committee should review The Brooking Institute Policy Brief #150 (attached) for a good discussion on timing risk.

How would the catastrophic loan product envisioned in Title II of the bill assist states, with or without catastrophe funds, in providing increased access to affordable homeowners' insurance to consumers?

While the loan provisions of Title II may offer some protection to state catastrophe funds in need of funds, H.R. 3355 does nothing that will affect the price of homeowners insurance. Alternatively, a national catastrophe fund *would* reduce the cost of homeowners insurance by replacing private reinsurance with public reinsurance. Studies by Milliman, Inc., a respected actuarial consulting firm, show that the cost of private reinsurance – primarily provided by offshore, unregulated companies -- can be 3 or 4 or even more times the cost of public reinsurance.

ProtectingAmerica.org advocates the establishment of a stronger public-private partnership as part of a comprehensive, integrated solution at the local, state and national levels. The solution would include privately funded catastrophe funds in catastrophe-prone states that provide more protection at lower cost to consumers. Much like the 401k retirement savings program, these CAT funds would grow tax-free, thus able to generate higher levels of reserves to provide greater levels of coverage in a shorter timeframe. These CAT funds would serve as a backstop to the private insurance market and would generate investment earnings that, in addition to helping to pay claims in the aftermath of a mega-catastrophe, would be used for mitigation, prevention, preparation and first responder programs.

We have also been advocating the creation of a national catastrophe fund that would serve as a backstop to participating state catastrophe funds in the event of a mega-catastrophe.

Those state catastrophe funds would be financed through mandatory contributions by insurance companies in each of those states in an amount that reflects the catastrophe risk of the policies that they write in each state.

The state funds would be required to set aside a minimum of $10 million up to a maximum of 35% of investment income for prevention and mitigation programs.

Qualified state funds would be able to purchase re-insurance from the national program. Rates for this coverage would be actuarially based and would only be available to state programs that have established the prevention and mitigation funding as described above.

In the event that a catastrophe strikes, private insurers would be required to meet all of their obligations to their policyholders. Should catastrophic losses exceed those obligations, the state catastrophe fund would be utilized. In the event of an extraordinary catastrophe, the national backstop program would provide benefits to the state and help pay remaining claims.

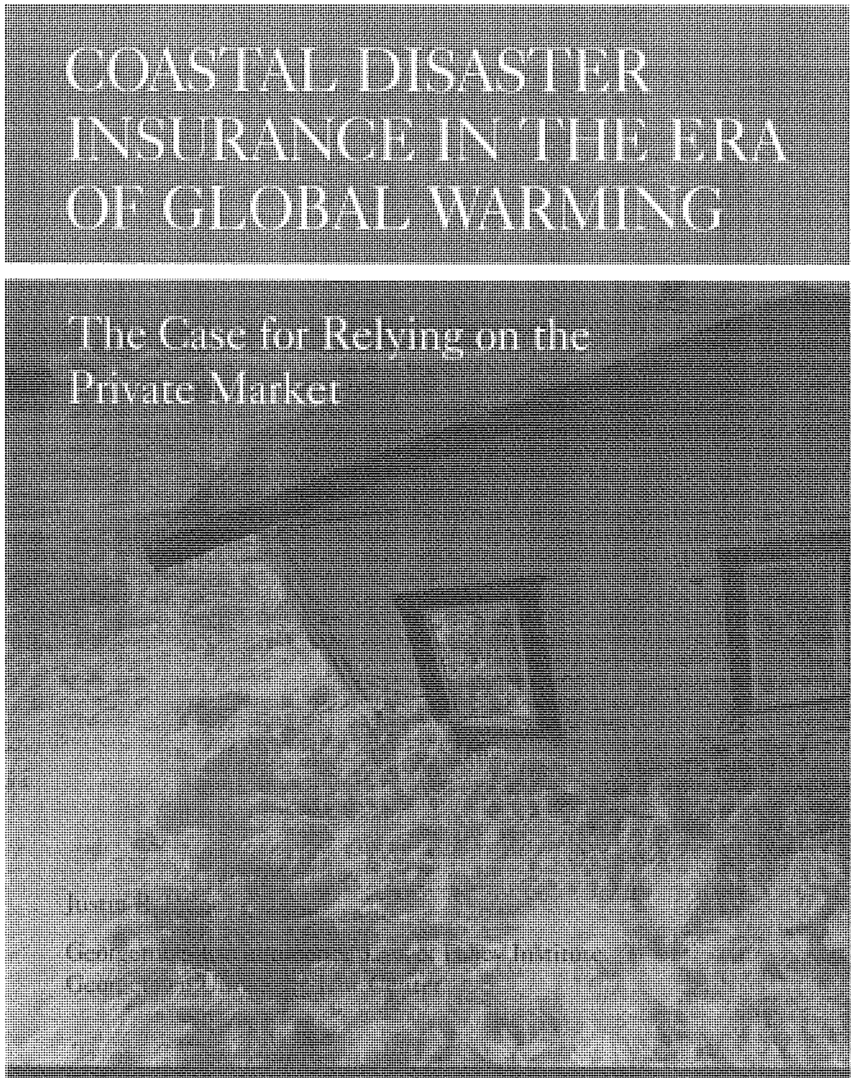
Because this is a state-by-state program based entirely on risk, the likelihood of a taxpayer subsidy is virtually eliminated. This approach requires pre-event funding and relies on private dollars from insurance companies in the areas that are most exposed to catastrophe.

Because this program relies on the traditional private market for paying claims, the inherent inefficiencies and bureaucracy in a government-run program are eliminated.

Because this program requires states to fund meaningful prevention and mitigation programs, catastrophe planning, protection and preparation will take place before the onslaught of catastrophe and will be in a state of continuous and rigorous improvement. ProtectingAmerica.org is cognizant of readiness and preparedness efforts underway by DHS, the Red Cross and the Council on Excellence in Government and is working hard to compliment that work.

This needs to be a top national priority. It reflects strong leadership to act before the next crisis. There is urgency and opportunity to act.

We also wish to thank Congresswoman Ginny Brown-Waite for her help in submitting ProtectingAmerica.org's statement for the record to the Financial Services Committee, and in particular, for her tireless leadership on this issue, forging bi-partisan support for legislation that would establish a workable private-public partnership as part of a comprehensive solution for future U.S. public policy on natural disasters.


COASTAL DISASTER
INSURANCE IN THE ERA
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The Case for Relying on the
Private Market

About the Author:

Justin R. Pidot is a Fellow at the Georgetown Environmental Law & Policy Institute. He graduated with distinction from Stanford Law School in 2006 where he was a co-Editor-in-Chief of the *Stanford Environmental Law Journal* and student in the Stanford Environmental Law Clinic. Prior to attending law school, Mr. Pidot coordinated outreach efforts in Washington State for the Save Our Wild Salmon Coalition. He graduated with a B.A. from Wesleyan University.

The Georgetown Environmental Law & Policy Institute conducts research and education on legal and policy issues relating to protection of the environment and conservation of natural resources. The Institute publishes papers and reports by leading academics and practitioners applying rigorous analysis to contemporary environmental and natural resource issues. The views expressed in Institute publications are those of the authors and do not necessarily reflect the views of the Institute's board of advisors or Georgetown University.

COASTAL DISASTER INSURANCE IN THE ERA OF GLOBAL WARMING

The Case for Relying on the Private Market

Justin R. Pidot

Georgetown Environmental Law & Policy Institute
Georgetown University Law Center

EXECUTIVE SUMMARY

This report examines proposals before Congress for the federal government to take on an expanded role in providing insurance to property owners threatened by hurricanes and other coastal storms. Its basic conclusion is that most of the pending proposals are misguided and, to the extent possible, the United States should stay out of the insurance business and allow private companies to provide disaster coverage that reflects its true market cost.

Proposals for greater federal intervention in coastal insurance are being driven by citizens' concerns about affordability and availability of insurance along the Atlantic and Gulf coasts of the United States, particularly in Florida, and public officials' understandable efforts to address them. Recent rate hikes appear to partly reflect a normal cycle in the insurance business following severe disasters, and a response to the boom in coastal development and the corresponding increase in coastal real estate values. But longer-term causes also may be at work, including the commencement of a natural cycle of heavy hurricane activity, a realization by the insurance industry that it had systematically underestimated potential economic losses from hurricanes and others storms, and the growing industry perception that global warming may produce more serious property damage in the future.

The current proposals before Congress to address the "crisis" in coastal insurance rates take three different forms. One proposal is to expand the forty-year-old federal flood insurance program to include coverage for wind damage from hurricanes and other storms. Another proposal is to make the United States a reinsurer (i.e., an insurer of insurance companies) for coastal insurance. The third proposal is to expand the ability of private insurance companies to offer coastal insurance by eliminating taxation of premiums that companies dedicate to reserve funds to pay for future catastrophic losses.

Our analysis indicates that proponents of federal intervention have failed to make the case for a significantly larger federal role in coastal insurance or that coastal disaster insurance cannot continue to be provided largely, if not exclusively, by private companies. Contrary to the proponents of the proposals, there is no convincing evidence that hurricanes represent an inherently uninsurable risk or that private companies lack the capacity to handle coastal disasters. While many citizens and elected representatives are understandably concerned about higher insurance rates and market cycles that temporarily leave some property owners uninsured, at the

end of the day these hurdles are not inherently problematic if they accurately reflect the risks associated with building in hazardous areas.

The report's analysis further indicates that a major new federal intervention in the private insurance market would likely have several unintended negative consequences, including imposing a potentially large financial burden on U.S. taxpayers, unfairly forcing those who live and own businesses in less hazardous areas to subsidize those in more hazardous areas, creating an incentive for additional coastal development that would increase the nation's long-term vulnerability to hurricanes and harm valuable coastal ecosystems, and displacing private insurance companies and stifling the development of new and innovative techniques to spread the risks posed by coastal hazards.

Policy makers could reasonably decide to provide some form of relief to some homeowners and certain other property owners who may have purchased property in hazardous coastal areas many years ago without understanding the risks involved. However, policy makers should draw a sharp distinction between long-time owners, on the one hand, and developers and new owners, on the other, to avoid subsidizing unwise decision making by those on notice about coastal hazards. In addition, this relief should take the form of targeted, direct payments to the intended recipients, not complex government insurance programs that would tend to distort the private marketplace.

In sum, the best federal policy appears to be one that does the least, that is, that largely leaves the business of providing insurance for hurricanes and other coastal storms to the private sector. Private insurance companies can generally provide appropriate coverage for the risks of property damage associated with hurricanes and other coastal storms while providing consumers reasonably accurate price signals about the dangers of building, living, and operating businesses in hazardous areas. Some states, Florida in particular, have arguably made reckless financial commitments to provide a short-term solution to the perceived crisis in insurance affordability and availability; many of the proposals before Congress would simply compound the problem by shifting responsibility for paying for these bad policy decisions to the federal taxpayer.

Our analysis shows that there are several useful, limited reforms that could be undertaken by the federal and state governments. The federal government could provide a valuable public service by generating maps and other information on how risks vary in different areas of the coast, which insurance companies could use to create more fine-grained rate structures that better

match the hazards associated with particular properties. State insurance regulators should consider making wind-damage coverage mandatory in coastal areas. In view of the overwhelming evidence that the national flood insurance program has been a public policy disaster, Congress should consider phasing it out over time. Finally, Congress should consider eliminating taxation of insurance premiums that companies commit to dedicated reserve funds to pay future catastrophic losses.

INTRODUCTION

In the wake of the record-breaking hurricane years of 2004 and 2005, the cost of insurance for wind damage increased dramatically and some insurance companies reduced the amount of insurance they offer in coastal areas. Global warming, which will likely increase flood damage and storm intensity, could push insurance rates still higher and make private insurance even more difficult to obtain. Some states have taken aggressive, risky, and expensive steps to ensure that coastal insurance remains affordable and available.

In response to this "insurance crisis," Congress is considering a series of proposals to federalize certain aspects of coastal insurance. Some elements of the insurance industry and various other advocacy groups have conducted a highly visible effort in support of some of these proposals. For instance, a major lobbying group named ProtectingAmerica.org, backed by the Allstate Corporation,[1] the second largest insurance company in the country, has placed full-page advertisements in major newspapers, stating "How do you deal with an enemy that has no government, no money trail and no qualms about killing women and children? The enemy is Mother Nature."[2] The answer, according to ProtectingAmerica.org, is to have the federal government shoulder a significant portion of the financial risk associated with catastrophic hurricanes.

The proper role of government and of the federal government in particular in the coastal insurance market presents a complicated policy problem. On the one hand, access to reasonably affordable property insurance is an important priority for American property owners. Therefore, it is hardly surprising that many citizens are concerned about the high price and lack of availability of insurance in the private market. Nor is it surprising that leaders in Congress feel a responsibility to consider these concerns.

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[1] Spencer S. Hsu, *Insurers Retreat from Coasts: Katrina Losses May Force More Costs on Taxpayers*, WASH. POST, Apr. 30, 2006, at A1 (noting that Allstate has contributed more than $1 million to ProtectingAmerica.org). Ironically, one of the chairmen of ProtectingAmerica.org, former FEMA Director James L. Witt, once championed changes to the National Flood Insurance Program to reduce subsidies, stating "It's time to quit wasting money and rebuilding in high risk areas. . . . If someone is going to build and live in a high-risk area, they ought to pay the price." Judy Warrick, *Seeking an End to a Flood of Claims*, NAT'L WILDLIFE MAG., June/July 1999 (quoting James L. Witt), *available at* http://www.nwf.org/nationalwildlife/article.cfm?issueID=45&articleID=537.

[2] Advertisement, N.Y. TIMES, Aug. 29, 2006, at A11.

On the other hand, the recent spikes in insurance rates reflect recognition of the true economic cost of developing property and choosing to live in hazardous coastal areas. As suggested in an insurance industry publication, "Though it would seem obvious, enormous effort continues to be expended in trying to escape the reality that where places, things, and people are expensive to insure, insurance will be expensive."[3] Federal financial support for ensuring the availability of coastal insurance has the potential to encourage more coastal development, place more citizens at risk, expand the vulnerability of the United States to hurricanes, and increase the cost of providing coastal property insurance. In weighing these arguments, there is an important distinction between established residents of coastal areas that may not have been aware of the severity of the danger posed by hurricanes when they purchased their properties and developers of new structures and potential new arrivals that are on notice about this hazard.

In approaching the issue of providing insurance for coastal hazards, Congress is not writing on a clean slate. In 1968, Congress established the National Flood Insurance Program ("NFIP") to provide insurance to property owners in flood zones, which include many coastal areas. The NFIP provides insurance for property damage due to flooding, and does not encompass wind damage. The current proposals before Congress are designed in effect to establish a new federal role in wind insurance that would match the role the federal government already plays in flood insurance. In fact, one of the pending proposals involves converting the NFIP into a multi-peril insurance program that would cover both natural hazards.

The current regime in which the federal government provides insurance for flood damage and private companies provide insurance for wind damage has given rise to numerous difficulties. From the perspective of a citizen whose home has been destroyed by a hurricane, the distinction between these two types of coverage may represent a meaningless technicality. Furthermore, in the aftermath of Hurricane Katrina, the wind-water distinction produced voluminous litigation about whether property damage was caused by one natural hazard or the other. It is understandable that some policy makers might respond by seeking to eliminate the distinction between wind and water damage by applying to wind risks the same policies the federal government has long applied to flood risks.

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[3] L. James Valverde, Jr. et al., *Global Climate Change and Extreme Weather: An Exploration of Scientific Uncertainty and the Economics of Insurance*, INSURANCE INFORMATION INSTITUTE WORKING PAPER SERIES 35 (2006).

However, this proposal begs the question whether the NFIP represents a successful model. As discussed below, the general view is that the NFIP has been a public policy disaster, both because of the burden it has imposed on the federal taxpayer and because it has failed to stem the tide of development in hazardous floodplains. While this report does not focus in detail on the flood insurance program, one option Congress should consider is phasing out the NFIP and fostering private-sector, multi-peril insurance.

Another basic question is the proper roles of the federal and state governments in addressing these issues. The states have traditionally taken the lead in regulating the insurance industry. According to proponents of federal intervention, however, the challenge of providing coastal disaster insurance is too big for the states to handle, requiring a larger federal role. At the same time, some states have taken on significant new liabilities in an effort to reduce the price their residents pay for hurricane insurance in the short-term. Some of the pending proposals in Congress can be viewed as an effort to foist onto the federal taxpayer the costly burden of fiscally questionable choices made at the state level.

This report seeks to unpack these complex issues as follows: Part I discusses the origins and nature of the coastal insurance crisis and discusses how global warming may exacerbate coastal insurance problems in the future. Part II describes current government insurance programs, including the National Flood Insurance Program, federal disaster assistance programs, and several state programs designed to make coastal disaster insurance more readily available to consumers at a reasonable cost. Part III discusses the current proposals in Congress to expand the federal government's role in coastal insurance. Part IV describes in theoretical fashion some economic challenges facing private companies in providing insurance coverage for hurricanes and other coastal storms. Part V discusses the challenges facing public policy makers in crafting a sensible approach to coastal insurance, particularly at the federal level. Part VI critically evaluates the primary arguments of the proponents of federal intervention in insurance for hurricane and other coastal storms. Part VII discusses some likely unintended adverse consequences of federal intervention. Finally, in Part VIII, we lay out a few useful, limited reforms that could be undertaken.

I. THE BROODING PERFECT STORM: AMERICA'S COASTAL "INSURANCE CRISIS"

In 2004 and 2005, the United States suffered record-breaking hurricanes, including seven of the thirteen most costly storms in American history.[4] In 2005, Hurricane Katrina caused more damage than any hurricane on record and the season as a whole set the record for the most number of named storms.[5] In response, the price home and business owners pay for insurance has dramatically increased and, in some areas, insurance can be hard to obtain on the private market at any price.

In Florida, according to a Mason-Dixon Poll, 42 percent of voters saw an increase in their insurance rates of more than $1,000 between 2005 and 2006.[6] In Louisiana, there are anecdotal accounts of businesses receiving notices increasing their rates five to ten-fold in a single year.[7] The Allstate Corporation announced that it would no longer write new policies in Florida, Louisiana, Mississippi, New York, and coastal Texas,[8] and that it would reduce by one quarter the number of existing Florida policies.[9] Similarly, State Farm has adopted a policy of no longer

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[4] ERIC S. BLAKE ET AL., NATIONAL HURRICANE CENTER, THE DEADLIEST, COSTLIEST, AND MOST INTENSE UNITED STATES TROPICAL CYCLONES FROM 1851 TO 2006 (AND OTHER FREQUENTLY REQUESTED HURRICANE FACTS), NOAA Technical Memorandum NEWS TPC-5 at 5 (Updated Apr. 15, 2007). These figures are indexed for inflation. NOAA also provides damage estimates indexed for changes in population and wealth. As a testament to the flood of money and people to the coasts, when such changes are taken into account, only three of the 2004 and 2005 hurricanes are among the top twenty most-damaging storms. *Id.* at 9.

[5] *Id.* at 5, 13.

[6] Matt Reed, *Insurance Rates Pummel Fla. Homeowners; Companies Say Increases Tied to Risk*, USA TODAY, Oct. 26, 2006, at A4.

[7] In recent congressional testimony, Mark Drennen, the president and CEO of an economic development organization in Louisiana, provided eleven examples of businesses experiencing astronomical increases in insurance premiums between 2005 and 2006, including a restaurant that faced an increase from $27,000 to $242,000; a health insurer that secured $200 million in coverage for $1.3 million but then was required to pay $6.3 million for $70 million in coverage the following year; and a country club that saw its premium increase from $60,000 to $100,000 while the deductible also increased from $10,000 to $250,000. *Stabilizing Insurance Markets for Coastal Communities Testimony Before the House Comm. on Financial Services., Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises*, Hearing 109-119, 109th Cong., at 122-123 (Sept. 13, 2006) [hereinafter September 2006 House Hearing] (statement of Mark Drennen, Greater New Orleans, Inc.).

[8] Hsu, *supra* note 1.

[9] Andrew Ward, *In Harm's Way: How America's Rush to the Coast is Driving up the Cost of Hurricanes*, FIN. TIMES, June 5, 2006, at 13.

offering insurance within one mile of the ocean[10] and announced that it would sell no new policies in Mississippi.[11]

This tumult in the insurance industry has produced a passionate public and media response. For instance, prior to the 2006 elections, more Florida voters ranked the cost of property insurance as their top priority than any other issue.[12] One candidate for the Florida state legislature noted that "What I spend my days talking about . . . is the thing that is strangling our pocketbooks . . . homeowners insurance."[13] Feeding off of the public mood, newspapers have run headlines like "Rising Insurance Rates Push Florida Homeowners to the Brink,"[14] "Wilma Spawns Insurance Crisis,"[15] and "Insurance Rates Skyrocket."[16]

The price spikes and availability shortages are attributable to a confluence of factors. First, these conditions are predictable market responses to the recent hurricanes, which required insurance companies to make large payments to policy holders. The payments diminished the financial reserves of many companies, eroding their ability to cover potential future claims. In response, insurance companies raised their rates to replenish their reserves, canceled some of their coverage to reduce their exposure, and entered into reinsurance contracts and took advantage of capital market instruments to lay off part of their risk.[17] These steps have led to rate hikes and reduced coverage, at least in the short term.[18]

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[10] Sandra Fleishman, *Sea Changes in Insurers' Coastal Coverage: Many Firms Opt to End or Limit New Policies*, WASH. POST, Dec. 30, 2006, at F1.

[11] Joseph B. Treaster, *State Farm Ends New Property Coverage in Mississippi*, N.Y. TIMES, Feb. 15, 2007, at C2. There is some question as to whether State Farm is withdrawing from Mississippi to gain leverage in ongoing negotiations with state regulators involving thousands of claims related to Hurricane Katrina. *Id.*

[12] Julie Pace, *Rising Rates a Top Priority: For Most Voters, Poll Shows Candidates Have Ideas on How to Stop Crisis*, TAMPA TRIB., Oct. 26, 2006, at Metro Section 1.

[13] Joni James, *What Voters Want is Policy on Insurance*, ST. PETERSBURG TIMES, Aug. 10, 2006, at A1.

[14] Lynn Waddell, *Rising Insurance Rates Push Florida Homeowners to the Brink*, N.Y. TIMES, June 29, 2006, at A13.

[15] Michael Turnbell et al., *Wilma Spawns Insurance Crisis*, S. FLA. SUN-SENTINEL, Oct. 23, 2006, at B7.

[16] Paige St. John, *Insurer's Rates Skyrocket; Citizens Proposes Increases of Almost 80 Percent for Some*, THE NEWS PRESS, Dec. 15, 2005, at 1A.

[17] Borrowing money directly from the capital market will often be a disfavored strategy because of its high cost. Depending on market conditions and regulatory factors, insurance companies may prefer to replenish capital reserves through higher premiums. *See* Neil A. Doherty & Lisa

Second, insurance companies have raised their rates based on a more accurate assessment of the risks facing coastal communities. Prior to Hurricane Andrew in 1992, hurricane experts believed that the worst possible storm could inflict no more than $10 billion in damage.[19] To the industry's dismay, Hurricane Andrew resulted in $15.5 billion in insured losses,[20] leading to a fundamental reassessment of coastal risk. After the hurricane years of 2004 and 2005, modelers of hurricane damage again increased their predictions of hurricane risk. Today's sophisticated models yield estimates that a worst-case hurricane could cause over $100 billion in insured losses.[22]

Third, scientists have determined that the Atlantic Multidecadal Oscillation ("AMO"), a twenty to forty year cycle in hurricane frequency and intensity, entered its intense phase in 1995.[23] This means that in the coming decades the United States is likely to be hit by more frequent hurricanes than it experienced in preceding years.[24]

Fourth, the steep price and limits on availability of coastal insurance reflect the enormous amount of valuable development that has occurred in the coastal zone, especially in the southeastern region of the country. The population of the United States has been moving toward the coast for decades, and today more than half the people in the country live within fifty miles of the ocean.[25] Between 1950 and today, the number of people living in hurricane-prone areas

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L. Posey, *Availability Crisis in Insurance Markets: Optimal Contracts with Asymmetric Information and Capacity Constraints*, 15 J. RISK & UNCERTAINTY 55, 56 (1997).

[18] Cycles of short-term supply constraints and higher rates followed by a return to equilibrium have been observed in other sectors of the insurance industry, including commercial insurance during the 1980s and medical malpractice insurance during the 1970s. *See id.* at 55.

[19] *See* Eugene Lecomte & Karen Gahagan, *Hurricane Insurance Protection in Florida, in* PAYING THE PRICE: THE STATUS AND ROLE OF INSURANCE AGAINST NATURAL DISASTERS IN THE UNITED STATES 97, 102 (Howard Kunreuther & Richard J. Roth, Sr., eds. 1998) [hereinafter PAYING THE PRICE] (citing BestWeek Property/Casualty Supplement, 1996).

[20] *Id.* at 99.

September 2006 House Hearing, *supra* note 7, at 35 (statement of Franklin Nutter, Reinsurance Association of America).

[22] Insurance Information Institute website, *Catastrophes: Insurance Issues*, http://www.iii.org/media/hottopics/ insurance/catastrophes [hereinafter III Catastrophes] (last visited July 25, 2007).

[23] *See generally* Stanley B. Goldenberg et al., *The Recent Increase in Atlantic Hurricane Activity: Causes and Implications*, 293 SCIENCE 474 (2001).

[24] *See id.* at 474.

[25] Ward, *supra* note 9.

between North Carolina and Texas more than tripled to 34.6 million.[26] Even after the devastation caused by Hurricane Katrina, approximately 1,000 people a day continue to move into the hurricane zone.[27] In 2005, Florida, the most hurricane-prone state in the nation, gained 321,697 residents, more new residents than any other state but Texas.[28] As Table 1 shows, many of Florida's most rapidly growing counties have been repeatedly hit by hurricanes.

Table 1. Hurricanes Affecting Florida's Ten Most Rapidly Growing Counties with Populations over 100,000 (1900-2006)

	2000 Population	2003 Population	Change	Tropical Storms	Mild Hurricanes	Severe Hurricanes
Osceola	172,483	205,870	19.3%	13	8	5
Lake	210,528	245,877	16.8%	15	8	2
Saint Johns	123,135	142,869	16.0%	22	5	1
Collier	251,377	286,634	14.0%	17	3	9
Santa Rosa	117,743	133,092	13.0%	10	4	3
Pasco	344,765	388,906	13.8%	9	6	2
Clay	140,814	157,502	11.9%	10	5	0
Lee	440,888	492,210	11.6%	11	0	7
Saint Lucie	192,695	213,447	10.8%	10	8	4
Hernando	130,802	143,449	9.7%	11	5	2

Sources: NOAA Coastal Service Center, maps.csc.noaa.gov/hurricanes/viewer.html
Population Growth - Florida Counties, www.epodunk.com/top10/countypop/copop10.html

Note: This table includes only storms the eye of which passed within 10 km of the county. Because many hurricanes are much wider than 10 km, these numbers probably underestimate the number of storms that could have caused damage within each county. Mild hurricanes are defined as those of force one and two on the Saffir-Simpson Hurricane Scale and severe hurricanes are defined as those of force three, four, and five.

Finally, higher insurance premiums reflect the rapid appreciation of real estate values in the coastal zone. All told, the value of insured coastal properties along the East Coast and the Gulf of Mexico doubled over the last decade; by the end of 2006, the value of insured property in this area exceeded $7 trillion dollars.[29]

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[26] Press Release, U.S. Census Bureau, Facts for Features: 2006 Hurricane Season Begins (May 22, 2006), *available at* http://www.census.gov/Press-Release/www/releases/archives/facts_for_features_special_editions/006838.html.

[27] Haya El Nasser & Paul Overberg, *Despite Storms, Coasts Fill Up*, USA TODAY, Oct. 21, 2005, at A1. USA Today included coastal areas between Virginia and Texas in its assessment.

[28] Press Release, U.S. Census Bureau, Louisiana Loses Population; Arizona Edges Nevada as Fastest-Growing State (Dec. 22, 2006), *available at* http://www.census.gov/Press-Release/www/releases/archives/population/007910.html.

[29] George Davis, *ISO HomeValue Incorporates Catastrophe Risk Assessments to Improve Personal Lines Underwriting Decisions*, AIRCURRENTS, Dec. 5, 2006, *available at* www.air-wordwide.com/_public /html/air_currentsitem.asp?ID=888.

The wild card for the coastal insurance business is the extent to which global warming will increase the hazards associated with coastal development and put even more pressure on insurance premiums. It is likely, at a minimum, that global warming will lead to a significant rise in sea level, increasing the amount of property at risk from storm-related flooding; scientists predict that a one-half meter rise in sea level would place six times more people at risk from storm surges.[30] Furthermore, the Intergovernmental Panel on Climate Change has indicated with more than a 66 percent confidence that global warming will increase hurricane and tropical storm activity.[31] While the scientific connection between global warming and hurricane strength and frequency is not yet clearly established, insurance companies must consider the risk that global warming is already increasing hurricane damage in assessing their current level of exposure on the coast.

All of these factors have combined to create the perception that the insurance market for property damage due to hurricanes and other storms is in the midst of a serious crisis, setting the stage for the current proposals being presented to Congress.

II. CURRENT GOVERNMENT PROGRAMS RELATED TO HURRICANE INSURANCE

Both federal and state programs already address, to some degree, insurance for property damage caused by hurricanes and other coastal storms. Before examining the current proposals before Congress, it will be helpful to lay out what already exists.

A. The National Flood Insurance Program

In 1968, Congress established the National Flood Insurance Program to provide home and business owners with insurance against flood damage. The NFIP has two primary elements.

[30] Robert J. Nicholls, *Coastal Flooding and Wetland Loss in the 21st Century: Changes Under the SRES Climate and Socio-Economic Scenarios*, 14 GLOBAL ENVTL. CHANGE 69, 70 (2003); *see also* Cornelia Dean, *Will Warming Lead to a Rise in Hurricanes?*, N.Y. TIMES, May 29, 2007, at F1 (noting that while most experts think climate change will increase hurricane frequency and severity, there is more of a scientific consensus that it will increase coastal flooding).

[31] GOVERNMENT ACCOUNTABILITY OFFICE, CLIMATE CHANGE: FINANCIAL RISKS TO FEDERAL AND PRIVATE INSURERS IN COMING DECADES ARE POTENTIALLY SIGNIFICANT, GAO-07-760T at 7 (2007); *see also* Robert L. Glicksman, *Global Climate Change and the Risks to Coastal Areas from Hurricanes and Rising Sea Levels: The Costs of Doing Nothing*, LOYOLA L. REV. (forthcoming 2007), *available at* ssrn.com/abstract=944866.

First, the program produces flood maps, demarcating 100-year floodplains,[32] which serve as the basis for the program's rate structure and mitigation requirements. Second, the program offers up to $250,000 in insurance against flood damage to homeowners in communities that have adopted floodplain regulations meeting minimum federal standards.[33] The program also offers up to $500,000 in coverage for non-residential properties.[34] As of 2005, about 20,000 communities, three quarters of those in the country, participated in the program.[35]

In adopting the NFIP, Congress proceeded on the assumption that it was impossible to rely on the private insurance industry to provide adequate insurance in flood-prone areas.[36] Advocates of federal intervention believed that flooding events were too unpredictable, and that the potential magnitude of the claims so enormous, that private insurance companies would steer clear. The validity of this crucial judgment is debatable, given that a number of other nations rely on private insurance companies to provide flood insurance.[37] In any event, since Congress made this judgment forty years ago, the federal government has provided most flood insurance coverage, including coverage for most water damage associated with coastal storms, and the private insurance industry has largely abandoned the field.

Because few property owners purchased insurance voluntarily during the early years of the program, Congress amended the NFIP to require owners within the 100-year floodplain with

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[32] A 100-year flood plain is an area that is expected to flood, on average, once every 100 years.
[33] 42 U.S.C. §§ 4012, 4013.
[34] *Id.*
[35] LLOYD DIXON ET AL., RAND, THE NATIONAL FLOOD INSURANCE PROGRAM'S MARKET PENETRATION RATE: ESTIMATES AND POLICY IMPLICATIONS at xv (2006) [hereinafter RAND NFIP STUDY]; GOVERNMENT ACCOUNTABILITY OFFICE, FEDERAL EMERGENCY MANAGEMENT AGENCY: CHALLENGES FACING THE NATIONAL FLOOD INSURANCE PROGRAM, GAO 06-174T at 2 (2005) [hereinafter GAO, CHALLENGES FACING THE NFIP].
[36] National Flood Insurance Act, P.L. 90-448 § 1302(b) (1968) (reciting finding that "many factors have made it uneconomic for the private insurance industry alone to make flood insurance available to those in need of such protection on reasonable terms and conditions").
[37] *See* SWISS RE, FOCUS REPORT, FLOODS ARE INSURABLE! (2002) [hereinafter SWISS RE I]; SWISS RE, FLOODS AN INSURABLE RISK? A MARKET SURVEY (1998) [hereinafter SWISS RE II] (identifying countries that provide flood insurance largely through private insurance companies, including: Argentina, Brazil, Canada, Czech Republic, France (with national reinsurance), Germany (storm surge excluded), Israel, Italy, Japan, Poland, Portugal, South Africa, Taiwan, and United Kingdom).

federally insured mortgages to purchase and maintain flood insurance.[38] Beginning in 1983, in another effort to expand participation in the program, the federal government permitted private companies to write NFIP coverage under the Write-Your-Own ("WYO") program.[39] Under the WYO, private companies write the policies and handle claims adjustment and, in exchange, receive 30 percent of the premiums as a sales commission and 3.3 percent of incurred losses for adjusting claims.[40] As of 2004, approximately 95 percent of NFIP policies were written under the WYO program.[41]

The NFIP is generally viewed as a colossal public policy failure. First, the program is a major burden on taxpayers because it has not been run in a financially responsible fashion. The program provides an explicit subsidy for structures built before a community joined,[42] charging owners of such properties an estimated 38 percent of the market rate.[43] As of 2000, approximately 30 percent of NFIP policies were for pre-existing buildings.[44] In addition, while owners of structures constructed or substantially improved after a community joined are supposed to be pay actuarial rates,[45] they too have been heavily subsidized. The subsidy arises

[38] Flood Disaster Protection Act of 1973, Pub. L. No. 93-234; National Flood Insurance Reform Act of 1994, Pub. L. No. 103-325. Despite this legislation, in 1997, only 27 percent of those with a high risk of flooding were thought to carry flood insurance. *See* Risa Palm, *Demand for Disaster Insurance: Residential Coverage, in* PAYING THE PRICE, *supra* note 19, at 51, 55. Today, penetration may have improved. The RAND Corporation recently estimated that approximately half of single-family homes located in 100-year floodplains now have flood insurance. RAND NFIP STUDY, *supra* note 35, at xvi; *see also* GAO, CHALLENGES FACING THE NFIP, *supra* note 35, at 8-10.
[39] *See* Adam F. Scales, *A Nation of Policyholders: Governmental and Market Failure in Flood Insurance*, 26 MISS. C.L. REV. 3, 14 (2006-2007).
[40] *See* Robert J. Rhee, *Catastrophic Risk and Governance After Hurricane Katrina: A Postscript to Terrorism Risk in a Post-9/11 Economy*, 38 ARIZ. ST. L.J. 581, 610 (2006).
[41] GOVERNMENT ACCOUNTABILITY OFFICE, FEDERAL EMERGENCY MANAGEMENT AGENCY: IMPROVEMENTS NEEDED TO ENHANCE OVERSIGHT AND MANAGEMENT OF THE NATIONAL FLOOD INSURANCE PROGRAM 13 (2005).
[42] 42 U.S.C. § 4015(c).
[43] GOVERNMENT ACCOUNTABILITY OFFICE, INFORMATION ON THE FINANCIAL CONDITION OF THE NATIONAL FLOOD INSURANCE PROGRAM, GAO-01-992T at 4 (2001) [hereinafter GAO, FINANCIAL CONDITION OF THE NFIP].
[44] GAO, FINANCIAL CONDITION OF THE NFIP, *supra* note 43, at 2.
[45] 42 U.S.C. § 4015(c) ("[T]he chargeable rate shall not be less than the applicable estimated risk premium rate for such area (or subdivision thereof) under section 4014(a)(1)"); 42 U.S.C. § 4014(a)(1) (stating that rates shall be based on "consideration of the risk involved and accepted actuarial principles," including the cost of administering the program).

from the fact that program managers have relied on a moving twenty-five year loss experience to set rates.[46] Because the NFIP had not suffered a catastrophic loss year prior to 2005, it charged premiums that did not generate reserves to protect against foreseeable, severe losses.[47] Furthermore, this backward-looking analysis failed to account for the continuously accelerating level of risk in the coastal zone, further underestimating the risks that covered properties would be flooded. As a result, when Hurricane Katrina struck, generating approximately $23 billion in claims, the NFIP paid for the vast majority of claims out of loans from the federal treasury that are unlikely to ever be repaid.[48]

Second, some property owners have received numerous payments because their properties flooded time and again. Unlike private insurers, which would almost certainly cancel coverage for such properties, federal officials are required to offer insurance to all comers in eligible communities, and have no authority to prevent rebuilding in hazardous areas. Repetitive loss properties make up roughly 1 percent of the NFIP properties but account for 38 percent of total insured losses.[49] In one particularly extreme case, the owner of a Houston area home valued at $115,000 received $807,000 based on fifteen flooding events over an eighteen-year period.[50]

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[46] *See* Scales, *supra* note 39, at 16.

[47] *Id.* In an additional demonstration of bureaucratic mismanagement, prior to Hurricane Katrina, the NFIP estimated that it faced a 1 in 1,000 chance of experiencing losses between $5.5 and $6 billion during a "catastrophic year." GAO, FINANCIAL CONDITION OF THE NFIP, *supra* note 43, at 2. However, at that time, many experts, including some within the U.S. Army Corps of Engineers, had predicted that even a category three hurricane could lead to massive failure of the New Orleans levees. *See, e.g.*, SENATE COMM. ON HOMELAND SECURITY AND GOVERNMENT AFFAIRS, SPECIAL REPORT, HURRICANE KATRINA: A NATION STILL UNPREPARED 133 (2006); Ivor L. van Heerden, Report, *Coastal Land Loss: Hurricanes and New Orleans*, Center for the Study of Public Health Impacts of Hurricanes, LSU Hurricane Center 6 (2003); Brian Wolshon, *Planning for the Evacuation of New Orleans*, ITE JOURNAL, Feb. 2002, at 44, 45 (2002).

[48] *See* RAWLE O. KING, CONGRESSIONAL RESEARCH SERVICE, NATIONAL FLOOD INSURANCE PROGRAM: TREASURY BORROWING IN THE AFTERMATH OF HURRICANE KATRINA 3 (2006) [hereinafter KING I].

[49] Spencer M. Taylor, *Insuring Against the Natural Catastrophe After Hurricane Katrina*, 20 NAT. RESOURCES & ENVT. 26, 30 (2006).

[50] Frencesca Ortiz, *The Tide is Nigh: Rethinking Urban Flood Management*, 9 CHAP. L. REV. 435, 438 (2006). In 2004, Congress passed the Bunning-Bereuter-Blumenauer Flood Insurance Reform Act of 2004, P.L. 108-264, to create a pilot program to provide state and local governments funding to purchase land that has been flooded multiple times in a single decade to prevent further losses to the NFIP.

Third, the NFIP has generally failed in the goal of controlling construction of additional structures vulnerable to flooding.[51] When Congress designed the NFIP, it was well aware that the program had the potential to encourage development in floodplains, thereby increasing the vulnerability of the nation to flood damage. As a 1966 Bureau of the Budget report explained:

> A flood insurance program is a tool that should be used expertly or not at all. Correctly applied, it could promote wise use of floodplains. Incorrectly applied, it could exacerbate the whole problem of flood losses. . . . [T]o the extent that insurance [is] used to subsidize new capital investment, it would aggravate flood damages and constitute gross public irresponsibility.[52]

Unfortunately, this dire possibility has turned into reality. By one estimate, more than 2.3 million buildings have been constructed in 100-year floodplains in communities after they joined the program.[53] This may help explain why the number of properties subject to repetitive-loss claims keeps climbing; in 1995, 75,000 homes experienced repetitive losses and by 2005 the number had climbed to 134,000.[54]

Finally, the NFIP has failed in its mission to maintain up-to-date flood maps. As of 2005, 70 percent of the 92,222 flood maps created under the NFIP were more than ten years old. But the properties in a community subject to flood risk constantly change in response to new development, shoreline and riverbank erosion, and other factors.[55] As a result, outdated flood maps fail to identify many properties that are within the current 100-year year floodplain. The

[51] The failure of land use planning to channel development away from floodplains predated the NFIP. As noted by two prominent members of the U.S. Geological Survey in 1955, "Flood zoning, like almost all that is virtuous, has great verbal support, but almost nothing has been done about it." WILLIAM G. HOYT & WALTER B. LANGBEIN, FLOODS 95 (1955).
[52] BUREAU OF THE BUDGET, A UNIFIED NATIONAL PROGRAM FOR MANAGING FLOOD LOSSES, House Document 465, 89th Cong. 17-18 (1966), quoted in Rutherford H. Platt & Claire B. Rubin, *Stemming the Losses: The Quest for Hazard Mitigation*, *in* DISASTERS AND DEMOCRACY: THE POLITICS OF EXTREME NATURAL EVENTS 69, 76-77 (1999).
[53] Raymond J. Burby, *Flood Insurance and Floodplain Management: The US Experience*, 3 ENVTL. HAZARDS 111, 116 (2001).
[54] Sabastian Mallaby, *Flood Insurance for Dummies*, WASH. POST, Oct. 9, 2006, at A17.
[55] GOVERNMENT ACCOUNTABILITY OFFICE, FLOOD MAP MODERNIZATION: FEDERAL EMERGENCY MANAGEMENT AGENCY'S IMPLEMENTATION OF A NATIONAL STRATEGY, GAO-05-894T at 2 (2005).

magnitude of the problem was underscored by a recent study that found that 20 percent of repetitive loss properties are currently located outside of the official 100-year floodplain.[56]

The problems plaguing the NFIP have persisted despite numerous efforts at reform. In 2006 testimony before Congress, the former Federal Insurance Administrator in the Ford and Carter administrations went so far as to question whether the program should be abandoned altogether.[57]

B. Federal Disaster Assistance

The federal government expends substantial resources on direct disaster assistance in the aftermath of hurricanes and other coastal storms. While not conventionally thought of as such, federal disaster assistance represents a form of insurance, albeit one funded with general tax revenues. Between 1990 and 2001, the Federal Emergency Management Agency ("FEMA") spent more than $27 billion in disaster assistance.[58] After Hurricane Katrina, Congress appropriated over $110 billion to assist affected states.[59]

Federal disaster assistance comes in a variety of forms and is used for many purposes. The majority of federal dollars are spent repairing public infrastructure.[60] Other disaster assistance is used to fund emergency operations during and immediately after natural disasters

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[56] *Proposals to Reform the National Flood Insurance Program Before the Senate Comm. on Housing and Urban Affairs*, 109th Cong. (Feb 2. 2006) [hereinafter Senate 2006 NFIP Hearing] (statement of David R. Conrad, National Wildlife Federation).
[57] *Id.* (statement of J. Robert Hunter, Consumer Federation of America). Mr. Hunter's suggestion is reluctant. During his testimony, he stated: "I love the National Flood Insurance Program. I poured 10 years of my life into getting it started. . . . I say this as background because I must sadly raise the question of whether the flood insurance program should be ended."
[58] GOVERNMENT ACCOUNTABILITY OFFICE, DISASTER ASSISTANCE: IMPROVEMENTS NEEDED IN DISASTER DECLARATION CRITERIA AND ELIGIBILITY, GAO 01-837 at 1 (2001) [hereinafter GAO DISASTER ASSISTANCE].
[59] *See The Road Home? An Examination of the Goals, Costs, Management and Impediments Facing Louisiana's Road Home Program Before the United States Senate Comm. on Homeland Security and Government Affairs, Subcomm. On Disaster Recovery*, 110th Cong. (May, 24, 2007) [hereinafter MAY 2007 DISASTER SENATE HEARING] (statement of Donald E. Powell, Department of Homeland Security). In the wake of Hurricane Katrina, the United States also received over $126 million in international disaster assistance. *See* GOVERNMENT ACCOUNTABILITY OFFICE, HURRICANE KATRINA: COMPREHENSIVE POLICIES AND PROCEDURES ARE NEEDED TO ENSURE APPROPRIATE USE OF AND ACCOUNTABILITY FOR INTERNATIONAL ASSISTANCE, GAO-06-460 at 1 (2006).
[60] GAO DISASTER ASSISTANCE, *supra* note 58, at 1.

Florida's Regulation of Hurricane Insurance

On the eve of Hurricane Andrew in 1992, Florida had a population of about thirteen million people and real property in the state had a value of about $421 billion.[a] Today, Florida has nearly sixteen million people, 80 percent of whom live within ten miles of the coast. The State continues to grow by leaps and bounds and is expected to top twenty-five million by 2025.[b] All told, real property in Florida is now worth more than $1.2 trillion.[c]

Since Hurricane Andrew, Florida has been shoulder-deep in the business of providing and reducing the cost of hurricane insurance. These efforts have taken three primary forms. First, Florida provides hurricane insurance directly to consumers through the Citizens Property Insurance Corporation ("Citizens"). Second, the state provides private insurers with reduced-cost reinsurance through the Florida Hurricane Catastrophe Fund ("FHCF"). Finally, Florida has used an array of regulatory tools to force reluctant insurance companies to continue selling property insurance in the state.

Citizens provides hurricane insurance to over 1.2 million homeowners in Florida.[d] In the past Citizens provided insurance at "above market" rates to avoid direct competition with the private sector. However, this changed in 2007, when a special session of the Florida Legislature enacted the Insurance Industry Accountability and Consumer Protection Act.[e] The most immediate impact of this legislation was cancellation of a planned 56 percent rate hike for Citizens' policyholders.[f] In addition, the act authorized Citizens to directly compete with private insurance companies.[g] Even charging "above-market" rates, Citizens has a bad track record for obtaining sufficient premiums to cover its losses. For instance, after the 2005 hurricane seasons, Citizens was more than $1.7 billion in the red.[h] The Florida legislature bailed the program out by appropriating $715 million from the state treasury. Citizens made up the remaining deficit by imposing a surcharge on all types of property insurance sold in the state.[i] Under the new legislation, Citizens now has the authority to impose surcharges on virtually every line of insurance, not just varieties of property insurance.[j]

The FHCF offers reinsurance to private insurance companies. It charges primary insurance companies a premium based on the risks they insure and, in exchange, will cover a portion of the losses from catastrophic hurricanes.[k] Unlike a private reinsurer, the FHCF can cover any shortfall it experiences by imposing an assessment on privately sold insurance or

raising money through the sale of bonds.[l] Under the 2007 law, the FHCF now provides $32 billion in coverage despite having only $1 billion in assets.[m]

Florida has also used a number of regulatory tools to prevent insurance companies from leaving the state. In the aftermath of Hurricane Andrew, Florida enacted a moratorium prohibiting insurance companies from canceling policies for coastal property owners.[n] During a phase-out period that lasted until 1996, companies were allowed to cancel no more than 10 percent of their policies per year.[o] In the 2007 legislative special session, the legislature resisted a call from the governor to impose a new four year moratorium. However, the 2007 law does require companies that market auto insurance in Florida to sell property insurance, including hurricane coverage, if they sell property insurance in other states.[p]

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[a] Data from the Florida Research and Economic Database, based on information from the Florida Department of Revenue, *available at* http://fred.labormarketinfo.com (select economic indicators then property value) (last visited July 26, 2007).
[b] COASTAL HIGH HAZARD STUDY COMMITTEE, FINAL REPORT 9 (2006).
[c] OFFICE OF INSURANCE REGULATION, THE PROPERTY INSURANCE MARKET IN FLORIDA 2004: THE DIFFERENCE A DECADE MAKES 22 (2004).
[d] Citizens Property Insurance Corporation website, http://www.citizensfla.com (last visited July 25, 2007).
[e] 2007 Florida H.B. 1A/C.S 1A (2007).
[f] Mary Ellen Klas & Marc Caputo, *Insurance Plan Would Lower Rates*, MIAMI HERALD, Jan. 22, 2007, at A1.
[g] MILLIMAN CONSULTANTS AND ACTUARIES, ANALYSIS OF FLORIDA LEGISLATIVE REFORM: SPECIAL SESSION, JANUARY 2007 17 (2007) [hereinafter MILLIMAN REPORT]; Klas & Caputo, *supra* note f.
[h] Waddell, *supra* note 14.
[i] *Id.*; MILLIMAN REPORT, *supra* note g, at 16 (noting that prior to 2007, Citizens had the authority to assess fire, allied lines, homeowners, farmowners, mobile homeowners, and commercial multi-peril insurance).
j *See id.* (noting that now Citizens can assess all but "workers compensation, medical malpractice, accident and health, National Flood Insurance, and Federal Crop Insurance").
[k] See Lecomte & Gahagan, *supra* note 19, at 111-12, for a history of the FHCF.
[l] MILLIMAN REPORT, *supra* note g, at 14-15.
[m] Peter Whoriskey, *Florida's Big Hurricane Gamble: To Cut Insurance Rates, State Pledges Billion for Future Claims*, WASH. POST, Feb. 20, 2007, at A2.
[n] For a detailed description of Florida's moratorium laws, see Jonathan B. Butler, Comment, *Insurers Under Fire: Assessing the Constitutionality of Florida's Residential Property Insurance Moratorium After Hurricane Andrew*, 22 FLA. ST. U.L. REV. 731 (1995).
[o] *See* Lecomte & Gahagan, *supra* note 19, at 110-11.
[p] Klas & Caputo, *supra* note f; Shelly Sigo, *Florida's Insurance Reform Legislation Plays the Odds Against New Bonding*, BOND BUYER, Jan. 25, 2007, at 8.

and to assist in cleanup operations.[61] The federal government also funds housing for displaced persons.[62] In addition, disaster assistance is used to facilitate economic recovery; the government provides subsidized loans to damaged businesses and may provide funding for economic revitalization programs in damaged areas.[63] Furthermore, following Katrina, the federal government provided affected states with $15 billion in Community Development Block Grants that could be used to provide payments to uninsured owners of property damaged by the 2005 hurricanes.[64] According to some federal officials, this funding was intended to compensate property owners without flood insurance that were damaged by storm surge or flooding because of the failed levees near New Orleans.[65]

C. State Catastrophe Programs

Unlike most segments of the U.S. economy, the insurance industry is primarily regulated by the states.[66] Each state legislature has delegated responsibility for enforcing its insurance law to an administrative body, in most cases a state insurance commission.[67] While insurance regulations vary, most states impose financial requirements on insurance companies in order to protect their solvency and conduct some type of review of insurance rates to ensure, in the

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[61] *See, e.g.*, GOVERNMENT ACCOUNTABILITY OFFICE, DISASTER ASSISTANCE: INFORMATION ON FEMA'S POST 9/11 PUBLIC ASSISTANCE TO THE NEW YORK CITY AREA, GAO-03-926 at 4-5 (2003).
[62] *See* GOVERNMENT ACCOUNTABILITY OFFICE, DISASTER ASSISTANCE: BETTER PLANNING NEEDED FOR HOUSING VICTIMS OF CATASTROPHIC DISASTERS, GAO-07-88 (2007).
[63] *See, e.g.*, GOVERNMENT ACCOUNTABILITY PROJECT, SMALL BUSINESS ADMINISTRATION: ACTIONS NEEDED TO PROVIDE MORE TIMELY DISASTER ASSISTANCE, GAO 06-860 at 11 (2006); GOVERNMENT ACCOUNTABILITY PROJECT, SEPTEMBER 11: OVERVIEW OF FEDERAL DISASTER ASSISTANCE TO THE NEW YORK CITY AREA, GAO-04-72 at 6 (2004).
[64] *See* MAY 2007 DISASTER SENATE HEARING, *supra* note 59 (statement of Donald E. Powell, Department of Homeland Security).
[65] *See, e.g.*, Peter Whoriskey, *La. Aid Discrepancy and Issue of Wind, Water: U.S. Officials Say Fund Was Limited to Flooded Homes*, WASH. POST, May 24, 2007 at A3.
[66] States regulate insurance under the McCarran-Ferguson Act, 15 U.S.C. §§ 1011 et seq., passed in 1945 to restore state authority following a U.S. Supreme Court decision, *United States v. South-Eastern Underwriters*, 322 U.S. 533 (1944), in which the Court ruled that the dormant commerce clause preempted state regulation.
[67] KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION: CASES AND MATERIALS 107-08 (4th ed. 2005).

language of many state laws, that rates are not "excessive, inadequate, or unfairly discriminatory."[68]

Thirty-two states and the District of Columbia have created Fair Access to Insurance Requirements Plans ("FAIR Plans") to provide coverage to some property owners that cannot secure insurance in the private market.[69] FAIR Plans were initially created to provide property owners in inner-city communities with insurance after widespread civil unrest broke out across the country in the late 1960s.[70] However, the scope of some of these programs has expanded and, today, Georgia, Massachusetts, New Jersey, and New York all provide insurance to coastal property owners through their FAIR Plans.[71]

Seven other states have created Beach and Windstorm Insurance Plans that provide insurance coverage specifically in coastal communities.[72] Between 1990 and 2005, the value of property insured by state FAIR Plans and Beach and Windstorm Plans increased from $40.2 billion to $387.8 billion.[73] In every state except Florida, these programs are under mandates to set rates "above market" to avoid direct competition with private insurance companies. Under a 2007 law, Florida's program can offer competitive insurance rates in high-hazard areas.[74]

Several states have created other types of programs to increase availability and reduce the cost of wind insurance. For instance, Florida has a catastrophe fund that provides inexpensive reinsurance to private insurance companies in order to reduce rates for hurricane coverage.[75]

[68] *See id.* FAIR Plans were established pursuant to the Housing and Urban Development Act of 1968, which, among other things, established a federal program to sell reinsurance for riot damage to state insurance programs that provided coverage to inner city communities.
[69] Insurance Information Institute website, *Residual Markets*, http://www.iii.org/media/hottopics/insurance/residual/, (last visited July 25, 2007) [hereinafter III Residual Markets].
[70] *See generally* Joanne Dwyer, Comment, *Fair Plans: History, Holtzman and the Arson-for-Profit Hazard*, 7 FORDHAM URB. L.J. 617 (1978-1979).
[71] *See* III Residual Markets, *supra* note 69.
[72] *Id.* Both Florida and Louisiana have merged their FAIR Plans and Beach and Windstorm Plans to respectively form the Citizens' Property Insurance Corporation and the Louisiana Citizens' Property Insurance Corporation.
[73] Insurance Information Institute, State-Backed Insurance Schemes: The Role of Insurers, London Institute Centenary Lecture (Mar. 6, 2006), *available at* server.iii.org/yy_obj_data/binary/769059_1_0/london.pdf.
[74] 2007 Florida H.B. 1A/C.S 1A.
[75] *See, e.g.*, website of the Florida Hurricane Catastrophe Fund, http://www.sbafla.com/fhcf (last visited July 25, 2007).

Other states are considering creating similar catastrophe funds.[76] Still other states have enacted tax measures to expand the availability of hurricane insurance. For example, in South Carolina, homeowners can deduct part of the cost of making their property more resistant to hurricanes and can set up tax-free hurricane savings accounts to pay their deductible if a hurricane strikes.[77] South Carolina also gives tax credits to insurance companies that provide hurricane insurance in high-risk areas.[78]

III. PROPOSED FEDERAL INTERVENTIONS

There has been a great deal of discussion in Congress about possible federal legislation on coastal hazards insurance. In the first half of 2007, there were at least three hearings examining the coastal insurance crisis and potential federal responses[79] and two additional hearings examining the broader potential impact of global warming on the insurance market.[80]

Not surprisingly, the congressional champions of federal legislation represent hurricane-prone states.[81] They are supported by an array of constituencies, including property owners

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[76] *See, e.g.*, LOUISIANA RECOVERY AUTHORITY SUPPORT FOUNDATION, LOUISIANA HURRICANE CATASTROPHE FUND ANALYSIS (2007); Governor Mark Sanford, State of the State Address (2007), *available at* www.stateline.org/live/details/speech?contentId=172223.

[77] III Catastrophes, *supra* note 22.

[78] *Id.*

[79] *Perspective on Natural Disaster Insurance Before House Comm. on Financial Services, Subcommittee on Housing and Community Opportunity*, 110th Cong. (Mar. 27, 2007) [hereinafter March 2007 House Hearing]; *An Examination of the Availability and Affordability of Property and Casualty Insurance in the Gulf Coast and Other Regions Before the Senate Comm. on Banking, Housing and Urban Affairs*, 110th Cong. (Apr. 11, 2007) [hereinafter April 11, 2007 Senate Banking Committee Hearing]; *Oversight of the Property and Casualty Insurance Industry Before the Senate Commerce, Science, and Transportation Comm.*, 110th Cong. (Apr. 11, 2007). There was also a hearing on the NFIP's coverage of hurricane damage. *National Flood Insurance Program: Issues Exposed by the 2005 Hurricanes Before House Financial Services Comm. Subcomm. on Oversight and Investigations and the House Homeland Security Comm. Subcomm. on Management, Investigations and Oversight*, 110th Cong. (June 12, 2007).

[80] *The Impact of Global Warming on Private and Federal Insurance, Before the Senate Comm. on Homeland Security and Government Affairs*, 110th Cong. (Apr. 19, 2007) [hereinafter April 19, 2007 Senate Hearing]; *Economic Impacts of Global Warming - Insurance Before the House Select Comm. on Energy Independence and Global Warming*, 110th Cong. (May 3, 2007) [hereinafter May 3, 2007 House Hearing].

[81] From Mississippi, Representative Gene Taylor introduced H.R. 920; from Louisiana, Representative Bobby Jindal introduced H.R. 164; and from Florida, Representative Ginny Brown-Waite introduced H.R. 91 and H.R. 330 and Representative Kendrick Meek introduced H.R. 537.

A Sampling of Interested Parties

Independent Insurance Agents & Brokers of America: This trade association represents independent insurance agents that act as intermediaries between consumers and insurance companies. The association supports a federal hurricane insurance program because "coverage is not sufficiently available at affordable rates.[a]

The National Association of Insurance Commissioners: This organization represents state insurance regulators. It supports formation of a commission to develop recommendations for reducing the price of insurance because, "[f]rom the perspective of insurance regulators, the key component is affordability, because if consumers in our states can't afford to buy the coverage, its availability is irrelevant."[b]

The Reinsurance Association of America: The Association represents reinsurance companies operating in the United States. It believes that "[t]he private reinsurance market is financially strong and diverse . . . [and] does not believe a federal role is appropriate."[c]

ProtectingAmerica.org: While this nonprofit organization represents a range of parties interested in catastrophe insurance, a large part of its funding comes from the Allstate Corporation. ProtectingAmerica.org supports the creation of a federal reinsurance program to "provide more protection at lower cost to consumers."[d]

National Association of Realtors: The Association represents the residential and commercial real estate industry and supports an array of proposals to reduce the cost of insurance, which "is a key component to financing the purchase of real estate." The Association argues that the real estate industry is "the linchpin of a healthy economy" and could be harmed by expensive insurance.[e]

Florida Chamber of Commerce: The Florida Chamber of Commerce states that one of the greatest threats facing the Florida business climate is "rising property insurance rates for coverage of hurricanes and other windstorm events."[f] The Chamber supports "legislation to stabilize the market and provide affordable, available property insurance to Florida business owners."[g]

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[a] April 19, 2007 Senate Hearing, *supra* note 80 (statement of Charles Chamness, National Association of Mutual Insurance Companies).
[b] *Id.* (statement of Walter A. Bell, President, National Association of Insurance Commissioners).
[c] March 2007 House Hearing, *supra* note 79 (statement of Franklin W. Nutter, Reinsurance Association of America).
[d] *Id.* (statement of Robert W. Porter, Executive Director of ProtectingAmerica.org).
[e] *Id.* (statement of F. Gary Thomas, National Association of Realtors).
[f] Frank Ryll, Jr., *Voice of Reason*, Monthly Column for Florida Chamber of Commerce website, Sept. 13, 2006, http://www.floridachamber.com.
[g] *Where We Stand*, Florida Chamber of Commerce website, http://www.flchamber.com/mx/hm.asp?id=leg_wws07_hurricaneinsurance (last visited July 25, 2007).

impacted by recent insurance rate hikes; developers and realtors promoting coastal development;[82] and some primary insurance companies that stand to profit from a government program that would assume some of the risk of catastrophic hurricane damage. Vocal opponents of government intervention are less visible. Reinsurance companies, which could be displaced by a new federal program, have argued that the private market can successfully insure hurricane risk.[83] Advocates of free-market approaches to social problems also have opposed federal intervention.[84]

There are three primary proposals pending in Congress:

Expanding the NFIP to Cover Wind Damage. The first proposal is to expand the scope of the National Flood Insurance Program to include wind damage from hurricanes and other storms. Under H.R. 920, the Multiperil Insurance Act of 2007, the Federal Emergency Management Agency would offer wind coverage to citizens on the condition that their communities adopt mitigation measures in accordance with federal guidelines.[85] FEMA would "encourage, where necessary, the adoption of adequate State and local measures which, to the maximum extent feasible, will assist in reducing damage caused by windstorms."[86] Unlike flood insurance, which is mandatory for all those with a federally insured mortgage that own property in high-hazard areas, coverage for wind damage would be optional.

H.R. 920 would establish a higher coverage limit for damage from wind than from floods. As noted, federal flood insurance currently provides up to $250,000 in coverage for a single-family home and $500,000 for nonresidential properties. H.R. 920 would provide coverage for wind damage up to $500,000 for a single-family home and $1 million for

[82] *See, e.g.*, March 2007 House Hearing, *supra* note 79 (Statement of Gary Thomas, National Association of Realtors).
[83] *See, e.g.*, September 2006 House Hearing, *supra* note 7, at 104-09 (statement of Franklin Nutter, Reinsurance Association of America).
[84] *See, e.g.*, CATO, CATO HANDBOOK FOR CONGRESS: POLICY RECOMMENDATIONS FOR THE 108TH CONGRESS 390 (Edward H. Crane & David Boaz eds. 2003); Statement of the Shadow Financial Regulatory Committee Meeting, American Enterprise Institute, Proposed Federal Catastrophe Reinsurance (2000), *available at* http://www.aei.org/publications/pubID.16544,filter.all/pub_detail.asp.
[85] H.R. 920 § 2 (c)(2).
[86] *Id.* at § 5(d)(2). This provision mirrors language in the National Flood Insurance Act. 42 U.S.C. § 4102; *see also* 44 C.F.R. § 60.1.

nonresidential properties.[87] Wind insurance, like flood insurance, would ostensibly be provided at an "actuarially sound" rate.[88] However, H.R. 920 reflects no recognition of the failure of FEMA to successfully determine risk-adjusted rates for flooding events,[89] and there is little reason to believe that an expanded version of the program would perform any better.

Providing Federal Reinsurance. Another proposal is for the federal government to become a reinsurer of catastrophic insurance. Congress is considering two bills adopting this approach, H.R. 91, the Homeowners Insurance Protection Act ("HIPA"),[90] and H.R. 330, the Homeowner Insurance Availability Act ("HIAA").[91] Both bills would provide excess of loss reinsurance for catastrophic natural disasters including hurricanes and other windstorms, earth quakes, tornados, and volcanoes.[92] HIPA would create a program providing reinsurance to state-run catastrophe funds and state insurers of last resort;[93] on the other hand, HIAA would provide reinsurance to a larger universe of entities including both private insurance companies and state insurance programs.[94]

Pricing of reinsurance policies would be done differently under each bill. Under HIPA, the Department of the Treasury would set the price for reinsurance contracts based on a number of factors including tbe level of risk facing each state program.[95] Under HIAA, the Department would divide the country into separate regions based on similarity of risk and auction off

[87] H.R. 920 § 2(7).
[88] H.R. 920 § 2(5).
[89] For discussion of FEMA's inability to charge risk-adjusted rates, see Section II.A, *supra.*
[90] Senator Bill Nelson from Florida has introduced, S. 928, a companion to HIPA.
[91] No Senate companion to HIAA has been introduced.
[92] H.R. 91 § 6; H.R. 330 § 4.
[93] H.R. 91 § 7. The federal government relied on a similar model for distributing reinsurance in the late 1960s and early 1970s under the Urban Property Protection and Reinsurance Act of 1968, Pub. L. 90-448, which provided federal reinsurance for damage caused by riots to insurance companies that participated in state FAIR plans. *See generally* Dwyer, *supra* note 70. The federal government created this program after a spate of urban riots swept forty-one states and the District of Columbia in the 1960s. Prior to that period, widespread civil unrest in urban areas had been largely unknown in the United States. *See* John R. Lewis, *A Critical Review of the Federal Riot Reinsurance System*, 38 J. RISK & INSURANCE 29, 29, 34 (1971). By the late 1990s, authorization for federal riot reinsurance had expired, ending the program. KEITH BEA, FEMA AND DISASTER RELIEF, Congressional Research Service 97-159 GOV at 6 (1998).
[94] H.R. 330 § 5.
[95] H.R. 91 § 7(b)(6).

Reinsurance

Reinsurance is essentially insurance for insurance companies.[a] By purchasing reinsurance, a primary insurance company (i.e., one that sells insurance policies to consumers) can protect itself against risk that it cannot otherwise diversify. This can occur because many primary insurers, unlike reinsurers, sell policies in limited geographic areas.

Reinsurers offer two distinct types of reinsurance, each of which plays an important role in expanding the capacity of primary insurers to assume hurricane risk. The first is excess of loss reinsurance, which protects the primary insurer from a "layer" of loss. For example, a primary insurer could take out a policy that would cover losses that exceed $10 million (the attachment point) until the losses reached $20 million, i.e., it would cover the $10 to $20 million loss layer. Typically, a reinsurer agrees to cover only some portion of the losses in the loss layer to ensure that insurance companies retain an incentive to minimize losses. Insurance companies will often purchase multiple layers of tiered reinsurance to cover losses of varying amounts. Excess of loss reinsurance increases the predictability of losses facing primary insurers, and thus decreases their risk exposure. This allows primary insurers to write additional policies without risking insolvency.

The second type of reinsurance is a proportional reinsurance policy. In a proportional reinsurance policy, the reinsurer agrees to pay some proportion of all losses faced by a primary insurer, typically in exchange for some portion of premium payments. Again, such a policy allows a primary insurer to underwrite additional policies.

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[a] For a detailed explanation of reinsurance, *see generally* ROSS PHIFER, REINSURANCE FUNDAMENTALS: TREATY AND FACULTATIVE (1996).

reinsurance contracts to insurance providers in each region.[96] During the auction, the minimum bid would be established by the Department based on an estimate of the risk facing the particular region.[97] Companies that made a winning bid could subsequently sell their contracts to other companies operating in their region.[98]

Advocates for both of these bills argue that rates would be actuarially sound and that the programs would be financially self-sufficient.[99] However, based on experience with the NFIP, these statements necessarily have to be taken with a grain of salt.

Reinsurance coverage would be provided in a slightly different form under each bill. Under HIPA, reinsurance would cover 90 percent of losses in excess of either the capacity of the state program or the projected losses from a 200-year event, whichever is greater.[100] Under HIAA, reinsurance would cover losses above a threshold based on the total claims received by providers in a particular region.[101] The Department would set the threshold at a level between the losses projected to occur from a 100-year event and from a 200-year event.[102] Once reinsurance liability was triggered, the government would cover 50 percent of the excess losses sustained by the holder of a reinsurance contract.[103]

Both bills would place a cap on federal liability. HIPA would limit the Department to selling reinsurance contracts that, in aggregate, are "unlikely to exceed" $200 billion in total losses, and would restrict each state to purchasing an amount of reinsurance that does not exceed projected losses from a 500-year event.[104] HIAA similarly would cap coverage in each region at the 500-year event level and further restrict aggregate coverage to a level "unlikely to exceed" $25 billion in losses.[105]

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[96] H.R. 330 § 5 (a).
[97] *Id.*
[98] *Id.* at § 5 (b)(2).
[99] GEORGETOWN ECONOMIC SERVICES, LCC, AN ANALYSIS OF CATASTROPHIC RISK INSURANCE PROPOSALS, PREPARED FOR THE FOUNDATION FOR AGENCY MANAGEMENT EXCELLENCE 18 (2007); HOUSE COMM. ON BANKING AND FINANCIAL SERVICES, REPORT, HOMEOWNERS' INSURANCE AVAILABILITY ACT OF 1998, 105TH CONG., Report 105-687 at 21 (1998).
[100] H.R. 91 § 8(b)-(c).
[101] H.R. 330 § 6 (b).
[102] *Id.*
[103] *Id.*
[104] H.R. 91 § 8(d).
[105] H.R. 330 § 7(c).

Both HIPA and HIAA would mandate that federal reinsurance should not compete with private reinsurers.[106] HIPA contains a further provision stating that participating state programs should not compete with the private sector.[107] However, this HIPA provision, which requires that state programs "not supplant coverage that is otherwise reasonably available and affordable in the private market," might prove difficult to enforce for two reasons. First, it is often difficult to determine whether a government program "competes" with the private sector because, once the government has entered a field, the private sector may be squeezed out. Furthermore, by making affordability a criterion for avoiding competition, HIPA implicitly authorizes the states to supplant the private sector when they believe private insurance rates are too high.[108]

Insurance Company Catastrophe Funds. A third proposal is to amend the federal tax code to permit insurance companies to avoid paying corporate income tax on premiums they place in dedicated funds to cover losses from catastrophic natural disasters.[109] Under current tax law, premiums are taxed as regular corporate income in the year in which they are received, even if a company wants to place the premiums in a reserve to cover potential future losses. Because companies must hold large amounts of surplus to protect themselves against low-probability events, this tax treatment can substantially increase the cost of providing hurricane insurance, up to 140 percent for insuring 200-year events by one estimate,[110] deterring companies from offering coastal disaster insurance.

H.R. 164, the Policyholder Disaster Protection Act, would authorize insurance companies to create Policyholder Disaster Protection Funds to cover a portion of losses associated with

[106] H.R. 91 § 4 (c) (stating that reinsurance contracts "shall not displace or compete with the private insurance or reinsurance markets or the capital market"); H.R. 331 § 2 (c) (same).
[107] H.R. 91 § 7 (a)(8).
[108] Both HIPA and HIAA include provisions that would allow private reinsurers to substitute for federal contracts to the extent they are willing to provide reinsurance that is "substantially similar" both in terms of coverage and price. H.R. 91 § 7 (c); H.R. 330 § 5 (d).
[109] The Policyholder Disaster Protection Act, H.R. 164. HIPA includes a similar provision to allow companies to create such reserves. Another bill, H.R. 1787, the Catastrophe Savings Accounts Act, targets consumer behavior, rather than the insurance industry, and would allow individuals to create tax exempt savings accounts to pay for damage they sustain from a federally declared natural disaster that is not covered by insurance.
[110] Scott E. Harrington, *Rethinking Disaster Policy*, 23 REGULATION 40, 42 fig. 1 (2000).

natural disasters that are officially designated catastrophes.[111] Companies could place surplus revenues in the funds up to a cap; the funds would not be permitted to grow larger than the total premiums for qualifying lines of insurance received by the company, adjusted by a designated multiplier.[112] In the event that the cap were exceeded, H.R. 164 provides a mechanism for the company to draw down the fund to the designated maximum level.[113]

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At the same time that Congress is considering these proposals addressing insurance for wind damage, it is also debating proposed amendments to the National Flood Insurance Program. H.R. 1682, the Flood Insurance Reform and Modernization Act would, among other things, (1) phase out subsidies for approximately 450,000 commercial properties and non-primary residences that receive preferential treatment because they were constructed before the community joined the NFIP; (2) authorize the NFIP to increase rates by up to 15 percent a year, up from the current limit of 10 percent annual increases; (3) increase the maximum coverage available under the NFIP; and (4) require the NFIP to have an ongoing program to update flood maps.

Table 2. Views of Selected Parties on Proposals Before Congress

	Federal Multi-Peril Insurance	Federal Reinsurance	Tax-Deferred Funds for Insurers
Bush Administration	O	O	
CATO Institute	O	O	F
Reinsurance Association of America		O	
ProtectingAmerica.org		F	
Independent Insurance Agents & Brokers of America		F	F
National Association of Realtors	F	F	F
American Insurance Association	O	O	O

Note: An F denotes being in favor of the measure and an O denotes being opposed.

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[111] H.R. 164 § 3 (adding section (h)(8) to section 832 of the Internal Revenue Code).
[112] For example, the fund may contain assets equal to 75 percent of total premiums for homeowners multiple peril insurance. *Id.* (adding section (h)(9) to section 832 of the Internal Revenue Code).
[113] *Id.* (adding section (h)(1)(B) to section 832 of the Internal Revenue Code).

IV. THE ECONOMICS OF HURRICANE INSURANCE

Policy makers weighing the appropriate role for the federal government in the hurricane insurance arena should consider some unique economic characteristics of this type of natural catastrophe insurance.

A. Large, Highly-Variable Losses

Hurricanes produce vastly different amounts of insured losses each year. This is in part because damaging hurricanes occur on an irregular basis, not only locally but also regionally, nationally, and even internationally. In 2004 and 2005, hurricanes hitting the U.S. coast caused tens of billions of dollars in property damage; by contrast, in 2006 there were no major hurricanes that struck the United States.[114] In addition, when a hurricane does strike in a particular area, it generally produces a large number of highly correlated losses. Hurricane Katrina, for example, led to the filing of approximately 1.75 million claims across four states.[115]

In these respects, providing insurance for hurricane damage is very different from providing insurance for other types of perils, such as automobile accidents. Automobile accidents are relatively frequent and each generally impacts a limited number of policy holders. Thus, as a result of the so-called "law of large numbers,"[116] a company that sells a sufficient number of auto insurance policies can predict the magnitude of the insurance claims it will receive each year with a fair degree of accuracy. Table 3 illustrates the difference between the predictability of auto insurance losses and the high variability of hurricane losses.

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[114] This comparison is slightly skewed by the fact that the Insurance Services Office excludes tropical storms that cause less than $25 million in insured losses from these statistics. However, including such storms would not change the highly variable nature of losses related to hurricanes.

[115] March 2007 House Hearing, *supra* note 79 (statement of Marc Racicot, American Insurance Association).

[116] To illustrate the law of large numbers, consider flipping a coin. As the coin is flipped more times, it becomes more likely that it will come up heads close to half the time. After 1,000 coin flips, it is exceedingly likely that the coin will have come up heads almost exactly 50 percent of the time. Similarly, if the average driver in a community faces a 2 percent chance of getting into an accident in a given year, a company that provides 10,000 car insurance policies will have to cover close to 200 car accidents by the end of the year.

Table 3. Insured Losses from Catastrophic Hurricanes and Automobiles, 2001-2005 (in millions of dollars)						
	2001	2002	2003	2004	2005	2006
Catastrophic Hurricanes	0	430	1,775	22,900	57,235	0
Automobiles	112	113	114	111	114	n/a

Sources: Insurance Information Institute website, Hurricanes, www.iii.org/media/facts/statsbyissue/hurricanes.
Insurance Information Institute website, Auto Insurance, www.iii.org/media/facts/statsbyissue/auto.
Note: Catastrophic hurricanes are defined by the Insurance Services Office as a single event that causes more that $25 million in damages to a significant number of policyholders and insurance companies. The damage figures provided have some overlap because damage to vehicles accounts for between 5 and 11 percent of hurricane losses. Total losses for automobiles were unavailable for 2006.

One possible response by insurance companies to the variability of claims based on hurricane damage is to build up reserves against potential future disasters. Another strategy is to diversify geographically by purchasing reinsurance from firms that operate around the globe. Through reinsurance, even a company operating in a narrow geographic market can avoid the possibility of serious financial losses from a major natural disaster.

B. Variable Vulnerability

Hurricane risk is not evenly distributed across coastal properties. In theory, insurance companies could charge a different amount for providing insurance to each property based on such factors as the property's proximity to the ocean, topography and nearby vegetation, construction methods and materials, and the character of neighboring buildings. However, risk evaluation is time-consuming and complex insurance programs are costly to administer. Furthermore, state insurance regulators tend to support the use of aggregate risk estimates because they disfavor complex rate structures and may prefer the apparent equity achieved by relatively level insurance rates.[117] In addition, insurance companies have a limited financial incentive to tailor rates to individual risk because they can obtain the same level of revenue from many policy holders paying an average premium as from the same group paying different, highly tailored amounts. Therefore, all other things being equal, companies prefer to use less costly,

[117] *See* COUNCIL OF ECONOMIC ADVISERS, ECONOMIC REPORT OF THE PRESIDENT 107, 119 (2007). The Council of Economic Advisers also warns that state regulatory approval processes can prevent insurance companies from rapidly adjusting premiums based on emerging information, and thus further undermine the ability of the industry to tailor premiums to risks. *Id.*

aggregate estimates of risk.[118] In practice, most insurance companies use a single premium for each zip code, and then apply their underwriting policies to decide whether to provide insurance to individual properties at that price.[119]

On the other hand, two factors tend to counterbalance insurance companies' incentive to use broadly applicable, average rates. First, as a result of adverse selection, the averaging approach may undermine a company's customer base over time. Adverse selection refers to the phenomenon in the insurance business that those individuals most likely to suffer a loss are those most likely to obtain insurance. If an insurance company uses an average premium across a broad area, it will tend to disproportionately attract high-risk customers. Everything else being equal, the greater the level of risk aggregation and the less consideration given to differences between properties, the greater the likelihood that a company's premium structure will undermine its long-term viability.

Second, potential competition from other insurance companies also counterbalances insurers' economic incentive to use average insurance premiums. A company that sets its rates by broadly averaging risk may lose more valuable, low-risk consumers to a competitor offering lower-priced, better-tailored policies. A new Florida insurance company provides an example of this type of competitive threat. The Privilege Underwriters Reciprocal Exchange ("PURE") recently started offering insurance in Florida for valuable homes (worth more than $1 million) that meet exacting engineering requirements.[120] In PURE's assessment, the owners of these properties, which are relatively unlikely to suffer serious hurricane damage, were being overcharged for insurance coverage, creating the opportunity for PURE to offer the same level of protection at a lower price. By incorporating more detailed information into its premium structure, PURE gained a competitive advantage over less-discriminating companies.

When no insurer will offer insurance for high-risk properties, secondary insurance providers may fill the gap. For instance, in Connecticut, state-licensed insurance companies are largely unwilling to provide property insurance to homes located within 1,000 feet of the ocean.

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[118] *See* ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW 114 (3rd ed. 2002) ("[D]ue to the expense of risk evaluation, an unbounded effort to categorize and subdivide risks in search of the fair rate would eventually lead to prohibitively expensive rates.").
[119] *See* MARK R. GREEN & JAMES S. TRISCHMANN, RISK & INSURANCE 106-07 (7th ed. 1988).
[120] Joseph B. Treaster, *Start-Up Insurer in Florida Pursues an Exclusive Niche*, NY TIMES, Mar. 6, 2007, at C3.

As a result, non-admitted insurance providers have become the major source of insurance for this area.[121] Non-admitted insurance is offered by providers that are not licensed by the state in which the property is located and thus have broader policy-writing and rate-setting discretion than licensed companies. Generally, consumers are permitted to purchase non-admitted insurance only when no admitted policy is available.[122]

C. Consumer Errors

The insurance business is further complicated by the difficulties consumers face in making fully rational decisions about obtaining insurance for low-probability events. Threshold bias, which refers to a consumer's tendency to treat low probabilities as zero probabilities, leads some consumers to not purchase hurricane insurance even if it is cost-justified in economic terms. The so-called salience and availability heuristics may lead consumers to underinsure if they have not recently experienced a hurricane and the nature of the risk they face is therefore not "salient" or "available" to them. On the other hand, if a property owner has recently experienced a hurricane, the "gambler's fallacy" may lead the owner to assume that such a low-probability event is unlikely to reoccur any time soon, and therefore forego obtaining insurance coverage.[123] In a striking illustration of how these psychological processes operate, a property owner of St. Bernard Parish near New Orleans described his decision to rebuild less than two

[121] CONNECTICUT INSURANCE DEPARTMENT, A REPORT ON THE AVAILABILITY OF HOMEOWNERS INSURANCE ALONG THE CONNECTICUT COAST 2 (2006) [hereinafter CONNECTICUT REPORT ON HOMEOWNERS INSURANCE], *available at* www.ct.gov/cid/lib/cid/app9_iso.pdf. Non-admitted policies can cost two to three times as much as traditional homeowners' policies and have engendered some controversy. *See* April 19, 2007 Senate Hearing, *supra* note 80 (statement of Florida Governor Charlie Crist) (describing the cost differences and noting that "[s]imilar problems are being felt" elsewhere).

[122] *See* PETER M. LENCSIS, INSURANCE REGULATION IN THE UNITED STATES: AN OVERVIEW FOR BUSINESS AND GOVERNMENT 87-90 (1997). Insurance providers offering non-admitted insurance escape state regulation by transacting their business outside of state lines. States do, however, regulate insurance brokers, generally requiring them to make a "diligent effort" to find coverage in the admitted insurance market.

[123] Neil A. Doherty et al., *Insuring September 11th: Market Recovery and Transparency*, 26 J. OF RISK & UNCERTAINTY 179, 186 (2003). In some circumstances, the gambler's fallacy and salience and availability may counteract each other. These effects could interact such that availability and salience create short-term spikes in demand immediately after a horrific natural disaster, but, as the vividness of the event recedes, the gambler's fallacy kicks in to depress demand for insurance.

years after Hurricane Katrina, stating "something like Katrina happens only once in a hundred years. . . . By that time, I'll be dead."[124]

The mortgage financing system provides a potential check on consumers' tendency to forego hurricane insurance. Many banks and other lenders require borrowers to secure and maintain insurance as a condition of a home loan. Furthermore, the federal government requires borrowers within designated flood zones to purchase and maintain flood insurance through the NFIP. However, these requirements are not always rigorously enforced. A recent study by the RAND Corporation concluded that, while the national compliance rate under the NFIP may be as high as 75 to 80 percent, in the Northeast and Midwest compliance may be as low as 45 to 50 percent.[125] Furthermore, these compliance rates have been achieved only after decades of effort to ensure that mortgage holders live up to their legal obligations.

Underutilization of hurricane insurance has various adverse consequences for the insurance system. It undermines the effectiveness of insurance as a risk-spreading device, particularly if large numbers of low-risk property owners opt out.[126] It also undermines the utility of insurance as a way of promoting socially useful behavior; if consumers forego purchasing insurance altogether they are missing market signals about the relative risks they are running. Finally, underutilization can contribute to greater volatility in insurance markets if consumers rush to obtain insurance after a hurricane but then fail to renew over time.

D. Moral Hazards

Another problem inherent in the insurance business is moral hazard, the tendency of those covered by insurance to run careless risks because they will not bear the financial consequences. For instance, an insured might tend to be negligent about closing storm shutters prior to a hurricane knowing that he will be indemnified for any loss. An extreme example of moral hazard is property owners in the flood plain who repeatedly rebuild, safe in the knowledge that they can file repetitive loss claims under the NFIP.

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[124] Peter Whoriskey, *New Orleans Repeats Mistakes as it Rebuilds: Many Houses Built in Areas Katrina Flooded Are Not on Raised Foundations*, WASH. POST, Jan. 4, 2007 at A1.
[125] RAND NFIP STUDY, *supra* note 35, at 23.
[126] Swiss Re, a European reinsurance company, discusses the importance of bringing low-risk property owners into the risk pool in two reports it produced discussing the insurability of floods. SWISS RE I, *supra* note 37; SWISS RE, FLOODS - AN INSURABLE RISK? (1998) [hereinafter SWISS RE III].

Insurance companies take various steps to control moral hazard. For example, some companies require customers to engage in hazard mitigation as a condition of retaining their insurance.[127] Companies also can employ high deductibles to force policy holders to absorb some of the economic loss from an insurable event.[128] Deductibles are particularly effective in promoting low-cost mitigation steps, like closing storm shutters. Deductibles are less effective in encouraging expensive measures, such as installing hurricane glass or outfitting a house with hurricane shutters,[129] because the owners receive only part of the benefits of increasing a property's resistance to storm damage but may bear all of the cost.[130]

V. THE POLITICAL ECONOMY OF HURRICANE INSURANCE

Alongside the special economic dynamics of the hurricane insurance business, there are also some peculiar political dynamics at work.

A. Dividing Public Liability from Public Regulatory Authority

A central feature of the United States' approach to natural hazard insurance has been a policy of assigning financial responsibility for coping with disasters to federal or state governments, while assigning responsibility for exercising regulatory authority to forestall

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[127] In some cases, however, insurance regulators may impede such efforts. For example, in 2007 the Connecticut Insurance Department published guidelines prohibiting insurance companies from canceling policies because a policy holder refused to engage in hurricane mitigation. STATE OF CONNECTICUT INSURANCE DEPARTMENT, FILING REVIEW GUIDELINES RELATED TO UNDERWRITING COASTAL HOMEOWNERS INSURANCE POLICIES at 3 (Jan. 23, 2007).

[128] Insurers also use deductibles to reduce their overall exposure to hurricanes by reducing the amount of compensation they must pay after an event. However, state regulators sometimes interfere; for instance, most coastal states in the eastern U.S. prohibit insurance companies from utilizing more than a 5 percent deductible in windstorm policies. AMERICAN INSURANCE ASSOCIATION, NATURAL CATASTROPHE AGENDA: TO REDUCE LOSS AND PROMOTE STABILITY 5 (2006).

[129] Hurricane glass can cost up to $35 to $50 per square foot, *Hurricane shutter guide: Compare types and calculate costs*, SUN SENTINEL website, http://www.sun-sentinel.com/news/weather/hurricane/sfl-hc-shutterguide,0,2678313.htmlstory (last visited July 25, 2007), and outfitting a house with hurricane shutters can cost over $40,000. David Royse, *Fla. Senate Says No to Requiring Storm Shutters in High-Risk Areas*, INSURANCE J., May 2, 2007.

[130] In some circumstances, state or federal grants may be available to help defray the cost of mitigation. *See, e.g.*, 42 U.S.C. § 4104c(e)(5) (grants eligible for flood-proofing and elevation of private structures under National Flood Mitigation Fund); III Catastrophes, *supra* note 22 (noting proposed and existing state programs to provide tax incentives for windstorm proofing).

disasters to local governments. At the same time, local governments have the most to gain from new development through increased local tax revenue. This situation has created a perverse set of incentives akin to those created by the moral hazard problem;[131] just as the availability of insurance causes property owners to be careless about controlling and mitigating risk, federal or state assumption of financial responsibility for natural disasters causes local governments to be relatively indifferent to the many public costs of pro-development regulatory policies in the coastal zone.

This perverse dynamic has plagued the NFIP from its inception. When Congress created the NFIP, it mandated that localities adopt land use regulations and other mitigation measures to protect the federal government from mushrooming liability. But those requirements have never been effectively enforced, with the result that the NFIP has actually spurred more growth in high-risk flood plains than would have occurred in the absence of the program.[132]

Local governments can sometimes actively obstruct the federal government's effort to reduce risk. In Biloxi, Mississippi, shortly after Hurricane Katrina, a member of the city council urged residents who had lost homes to rebuild quickly to avoid an expected announcement from the NFIP that buildings would have to meet higher elevation requirements.[133] This recommendation made sense from the city's perspective because it would bear little direct financial risk from greater hurricane vulnerability but would reap larger tax revenues from rebuilding. In the words of the President of the Insurance Information Institute, "The bottom line is that coastal development is economically rational from the perspective of coastal stakeholders only because most benefits are retained locally while a high proportion of costs are redistributed to others."[134]

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[131] *See* Erwann O. Michel-Kerjan, *Disasters and Public Policy: Can Market Lessons Help Address Government Failures?*, 60 NAT. TAX J. (forthcoming), *available at* http://opim.wharton.upenn.edu/risk/library/07-04.pdf.

[132] REPORT, HOUSE OF REPRESENTATIVES BIPARTISAN NATURAL DISASTERS TASK FORCE 1 (1994), quoted in RUTHERFORD H. PLATT, DISASTERS AND DEMOCRACY: THE POLITICS OF EXTREME NATURAL EVENTS 39 (1999).

[133] Kellie Lunney, *A Tale of Two Cities*, NAT. J., July 29. 2006, at 32.

[134] April 19, 2007 Senate Hearing, *supra* note 80 (statement of Robert P. Hartwig, Insurance Information Institute).

Recent hurricane-related legislation in Florida has created the same kind of problem at the state level. In 2007, the Florida legislature took aggressive action to reduce hurricane insurance premiums by having the state assume financial responsibility for more than $32 billion in potential liability.[135] At the same time, hurricane-prone communities in Florida have resisted enacting land use and mitigation restrictions. The City of Punta Gurda has proposed an extensive waterfront redevelopment plan in areas devastated by Hurricane Charley that would actually move buildings closer to the water.[136] In the City of Pensacola, struck by Hurricane Ivan, the mayor has opposed any restrictions on development, suggesting that "the free market drives [development], the way it should be."[137] However, all of Pensacola's state legislators voted in favor of the Florida legislation making the state government financially responsible for hurricane damage exacerbated by poor local land use planning.[138]

B. The Wind Versus Water Dichotomy

The U.S. approach to disaster insurance has created a house divided — between water damage and wind damage. In general, private companies offer insurance against wind damage while the federal government covers damage from storm surges and other flooding through the NFIP. This dichotomy does not, of course, reflect the reality of hurricanes and storms. Property damage is often caused by a mix of wind and water. In addition, because the damage often occurs in the middle of a dangerous storm, it may be difficult if not impossible to determine the proportional share of damage caused by one or the other.

The wind-water dichotomy has generated considerable consumer dissatisfaction. Many consumers who purchase insurance against windstorms do not appreciate the importance of policy exclusions for water damage or of anti-concurrent causation provisions. Anti-concurrent causation provisions, the source of many lawsuits after Hurricane Katrina, exclude from coverage damage that is caused by both a covered peril (like wind) and an uncovered peril (like

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[135] Peter Whoriskey, *Florida's Big Hurricane Gamble: To Cut Insurance Rates, State Pledges Billion for Future Claims*, WASH. POST, Feb. 20, 2007, at A2.
[136] Baird Helgeson, *Risky Rebuilding*, TAMPA TRIB., Nov. 5, 2006, at 1. The Mayor of Punta Gorda went so far as to suggest that "[Hurricane] Charley did us a favor . . . . What you are going to see in the next couple of years would have taken 15 years [before the Hurricane]."
[137] *Id.*
[138] Indeed, the hurricane insurance bill passed the Florida Senate unanimously; only two representatives voted against it.

water).[139] After a hurricane, consumers have been distraught to discover that they were not covered for all (or sometimes any) of the resulting damage because it was either caused by water or jointly caused by water and wind.

The wind-water dichotomy also has created both an opportunity and an incentive for insurance companies to avoid paying claims by improperly classifying damage as flood damage. For consumers without flood insurance, this tactic has sometimes led to a total denial of compensation. For those that do have flood insurance, the federal government is burdened with paying their claims. Under the NFIP's "Write Your Own" program, private insurers often administer and adjust NFIP claims for the federal program.[140] Thus, in many circumstances, a single company provides private wind coverage and administers federal flood insurance, creating powerful pressure on adjusters to characterize damage as flood damage and thereby shift losses to the federal government.[141] Currently, the federal government collects insufficient information to assess whether and to what extent insurance companies abuse their role as NFIP claims adjusters to improperly characterize losses.[142]

There is evidence that in the wake of Hurricane Katrina insurance companies both shifted losses to the federal government and improperly denied claims for those without flood insurance. Two former claims adjusters have alleged that State Farm Insurance officials instructed them and others to attribute damage to flooding, quickly pay NFIP claims, and deny that properties suffered any wind damage.[143] Disputes over whether insured property owners had been improperly denied compensation also sparked massive litigation,[144] much of it brought by those lacking flood insurance, who constitute more than half of property owners in New Orleans,[145]

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[139] *See* Scales, *supra* note 39, at 23-24.
[140] FEMA, NATIONAL FLOOD INSURANCE PROGRAM: PROGRAM DESCRIPTION 22-23 (Aug. 1, 2002).
[141] *See Id.* at 36-38.
[142] *See* GOVERNMENT ACCOUNTABILITY OFFICE, NATIONAL FLOOD INSURANCE PROGRAM: PRELIMINARY VIEWS ON FEMA'S ABILITY TO ENSURE ACCURATE PAYMENTS ON HURRICANE-DAMAGED PROPERTIES, GAO-07-991T at 2-3 (2007).
[143] GENE TAYLOR & CHARLIE MELANCON, KATRINA AND BEYOND: RECOMMENDATIONS FOR LEGISLATIVE ACTION 1 (2007); *see also* Rebecca Mowbray, *Insurers Accused of Milking System: Attorney Lets Loose to N.O. Lawyers*, TIMES-PICAYUNE, May 5, 2007, at Money Sec. 1.
[144] *See* Scales, *supra* note 39, at 23-29, for an excellent discussion of the litigation and the contract provisions at its heart.
[145] Editorial, *Rethinking Flood Insurance*, WASH. POST, Sept. 21, 2005, at A22.

and more than 80 percent of those in coastal Mississippi.[146] Residents in Mississippi alone have filed over 2,000 lawsuits.[147] State Farm Insurance, Mississippi's largest provider of home insurance, recently settled with 640 claimants for $80 million and agreed to reopen the claims process for 36,000 other homeowners, promising to provide them with at least $50 million in compensation.[148]

C. The Public Choice Problem

Government regulation of insurance for hurricanes and other coastal storms presents a classic public choice problem.[149] Public choice theory suggests that political leaders, constantly facing popular elections, will often be tempted to respond to the short-term demands of vocal, highly motivated factions, even at the expense of their constituents as a whole.[150]

Coastal property owners facing dramatic increases in insurance rates, or altogether unable to obtain private market insurance, represent the kind of highly motivated interest group that can exert powerful political pressure. As mentioned previously, prior to the 2006 elections, more Floridians ranked insurance as their top priority than any other issue. The political significance of hurricane insurance is compounded by the fact that those living closest to the ocean, and thus at most risk from hurricanes, tend to be disproportionately affluent and well-connected.[151]

On the other hand, those who would be adversely affected by aggressive federal action to reduce the cost of hurricane insurance, even if more numerous, may not be able to exert as much political influence. An increased tax burden may be too abstract, and may be affected by so many other government policies, to generate a significant political response. Many citizens may object in principal to subsidizing coastal development, but such objections may not translate into voting decisions. Furthermore, many of the adverse consequences of subsidizing coastal development, such as greater risks to life and limb and the possibility of massive federal liability

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[146] Joseph B. Treaster, *A Lawyer Like a Hurricane; Facing Off Against Asbestos, Tobacco and Now Home Insurers*, N.Y. TIMES, Mar. 16, 2007, at C1.
[147] *Id.*
[148] *Id.*; Joseph B. Treaster, *State Farm Skirts Judge in New Hurricane Plan*, N.Y. TIMES, Mar. 20, 2007, at C4.
[149] Soon after Hurricane Andrew, Professor Marc Poirier provided a thorough analysis of the public choice dynamics of natural hazard policy. Marc R. Poirier, *Takings and Natural Hazards Policy: Public Choice on the Beachfront*, 46 RUTGERS L. REV. 243 (1993).
[150] *See generally* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1971).
[151] *See* Poirier, supra note 149, at 260.

sometime in the future, may have little current political valence.[152] Many politicians may not be in office when the harms from today's unwise policy choices are realized.[153]

D. The Need to Respond to Citizens in Crisis

Finally, the challenge of crafting sensible coastal insurance policy is complicated by the obligation of the government, aided by the private sector, to respond to hurricanes and similar events with disaster relief. The catastrophe wrought by Hurricane Katrina riveted Americans across the country, prompting Congress to dedicate billions of dollars to assist in the Gulf recovery effort and leading to hundreds of millions of dollars in private donations to relief organizations.[154] While there is continuing debate about whether the response has been adequate or well managed, there is no room for debate that it was a national priority to respond to those in need following Hurricane Katrina.

One policy concern, however, is that, depending on how disaster relief is designed, the relief may have the perverse effect of encouraging people to forego purchasing insurance.[155] Most of the post-Katrina disaster relief was spent on emergency services, temporary housing and food for disaster victims, and funding to communities to rebuild public infrastructure. But a small portion of the funds has been dedicated to providing rebuilding assistance to homeowners who were uninsured or underinsured. In effect, the government took on the role of a retroactive insurer, using taxpayer funds to provide compensation. If this approach encourages other coastal residents to forego voluntarily purchasing insurance in the future, citizens may be more

[152] *Cf.* COUNCIL OF ECONOMIC ADVISORS, *supra* note 117, at 116 (noting that "the NFIP was able to cover losses in most of the program's recent history, but . . . exposed the American taxpayers to a huge potential financial liability which became an actual liability in 2005").
[153] State mandated term limits on government officials may exacerbate the short-sighted view of elected officials. In Florida, for instance, term limits prohibit any person from serving more than eight years as governor or as a member of either house of the state legislature. *See* National Conference of State Legislatures website, http://www.ncsl.org/programs/legismgt/about/states.htm (listing term limits for each state's legislatures) (last visited July 25, 2007); U.S. Term Limits website, http://www.ustl.org/Current_Info/State_TL/gubernatorial.html (listing term limits for each state's governor) (last visited July 25, 2007).
[154] *See, e.g.*, Press Release, Bush-Clinton Katrina Fund, Dec. 20, 2006 (noting that the fund had raised over $130 million).
[155] *See, e.g.*, U.S. HOUSE OF REPRESENTATIVES BIPARTISAN TASK FORCE ON DISASTERS REPORT 1 (Dec. 14, 1994), quoted in PLATT, *supra* note 132, at 234 ("If homeowners mistakenly believe that the Federal Government will rebuild their homes after a natural disaster, they have less incentive to buy all-hazard insurance for their homes.").

financially vulnerable when the next hurricane strikes. In addition, current and future residents of coastal areas who avoid purchasing insurance would be missing an important economic signal about the costs of living along the coast.

In the midst of tragedy, it can be challenging for government to formulate sensible policy to respond to the needs of disaster victims. At such moments, it is of paramount importance to recognize that those that suffer from natural disasters are often not just victims of Mother Nature, but also of development policies that placed them in harms way and masked the natural hazards they faced.[156]

VI. THE ARGUMENTS FOR FEDERAL INTERVENTION

An array of arguments has been presented for federal intervention in the coastal insurance business, including assertions that "there is currently a clear case of market failure,"[157] that "the unpredictability and scope of potential catastrophes are beyond the means of the private sector alone,"[158] and that "the insurance industry is broken and as a result the state [of Florida] is facing an economic crisis."[159] Based on a review of the testimony presented to Congress, as well as the academic literature and various other publications, we have identified three basic policy arguments in favor of federal intervention: (1) that hurricane risk is not insurable; (2) that the private insurance industry lacks the capacity to make hurricane insurance widely available; and (3) that property owners' insurance rates are simply too high and have risen too rapidly. We address each of these arguments below.

A. The Insurability of Hurricane Risk

The first argument is that hurricanes and other coastal storms are uninsurable by private insurance companies. Proponents of this argument contend that the occurrence of hurricanes is too rare and unpredictable, and the resulting claims when disaster strikes too highly correlated,

[156] *See* TED STEINBERG, ACTS OF GOD (2000) (discussing the ways that human activity puts people and property at risk from natural disasters); Richard J. Lazarus, *Environmental Law After Katrina: Reforming Environmental Law by Reforming Environmental Law-Making*, 81 TUL. L. REV. 1019 (2007) (discussing the way that public policy contributed to the damage caused by Hurricane Katrina).
[157] March 2007 House Hearing, *supra* note 79 (statement of Andrew Valdivia, Independent Insurance Agents & Brokers of America).
[158] *How a catastrophe fund will protect America*, ProtectingAmerica.org website, http://www.protectingamerica.org/?SecID=24 (last visited July 25, 2007).
[159] March 2007 House Hearing, *supra* note 79 (statement of U.S. Representative Tim Mahoney).

for a private insurance system to function effectively.[160] While this argument is certainly not trivial, the available evidence suggests that hurricane risks are insurable, and they are becoming more so each year with advances in forecasting and the emergence of increasingly sophisticated risk-spreading instruments.

Some risks are not insurable. For instance, no insurance company will sell a policy covering intentional actions, such as arson, and some events may be too unpredictable and potentially disastrous to be insurable. The risk of a terrorism attack is arguably such a risk because attacks are extremely infrequent, their occurrence is highly unpredictable, they could wreak untold damage, and the resulting damages are too correlated to allow for effective risk pooling.[161] While hurricanes present serious challenges to the insurance industry, they do not fall into the category of uninsurable risks.

Hurricanes are hardly an every day event but, unlike terrorism attacks, their occurrence can be predicted with fair accuracy. The National Oceanic and Atmospheric Administration has identified 1,320 named tropical storms, 799 hurricanes, and 282 major hurricanes (defined as a hurricane scoring a 3, 4, or 5 on the Saffir-Simpson Hurricane Scale) that occurred in the Atlantic Basin (including the Gulf of Mexico and Caribbean Sea) between 1851 and 2004.[162] Furthermore, hurricanes have become more frequent in recent years. Indeed, one commentator has suggested that, "At a country level, the last five years have demonstrated that . . .[hurricane] catastrophes are not low probability anymore."[163] In addition, insurance companies have developed increasingly sophisticated risk models to estimate the damages that could result from different hurricanes and the level of potential exposure facing their portfolio of insurance policies.[164]

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[160] *See, e.g., id.* (statement of Gary Thompson, National Association of Realtors) ("Some disasters are just too large or unpredictable for the private market to deal effectively with the resulting damage ."); *see also, e.g.*, Robert H. Jerry II & Steven E. Roberts, *Regulating the Business of Insurance: Federalism in an Age of Difficult Risk*, 41 WAKE FOREST L. REV. 835, 836-37 (2006).

[161] *See* Michelle E. Boardman, *Known Unknown: The Illusion of Terrorism Insurance*, 93 GEO. L.J. 783, 784 (2005).

[162] NOAA, Hurricane Research Division website, *Frequently Asked Questions*, http://www.aoml.noaa.gov/hrd/ tcfaq/E11.html (last visited July 25, 2007).

[163] Michel-Kerjan, *supra* note 131, at 12.

[164] However, neither New York nor Georgia permit insurance companies to rely on computer based models in ratemaking. AMERICAN INSURANCE ASSOCIATION, *supra* note 128, at 4.

Uncertainty about the timing of hurricanes does lead insurance companies to charge higher premiums for this type of coverage,[165] a phenomenon called "risk loading." Higher premiums compensate insurance companies for the cost of holding capital against unpredictable future losses. However, risk loading simply means that hurricane insurance is relatively expensive, not that there has been a market failure.

The problem of correlated risk — when a disaster strikes, many property owners are likely to be affected and file claims for compensation — presents another challenge, but again not an insurmountable one.[166] Correlated risk poses a particular problem for companies that provide insurance within a limited geographic area, because a major disaster can produce thousands of claims depleting their reserves and threatening their solvency. But private insurers have developed a number of techniques to diversify catastrophic hurricane risk.

First, there are significant opportunities to diversify the risk of hurricane damage geographically. Nineteen states and the District of Columbia lie within the reach of hurricanes in the Atlantic basin and Pacific hurricanes can strike Hawaii. Furthermore, coastal countries around the world are exposed to hurricane threats. In an average year, fifteen tropical storms approach coastlines somewhere on Earth.[167] Hurricane risk also can be pooled with other types of catastrophic risks, such as hail, tornado, or earthquakes.[168] Pooling numerous different natural hazards can reduce the gap between actual losses and estimated losses in any given year. International reinsurance companies and capital markets provide avenues for even small, locally-based insurance companies to take advantage of this kind of broad risk spreading.[169]

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[165] *See, e.g.*, Howard Kunreuther, *Insurability Conditions and the Supply of Coverage*, *in* PAYING THE PRICE, *supra* note 19, at 17, 33.

[166] *See* Jerry & Roberts, *supra* note 160, at 844.

[167] *See* R. K. Turner et al., *Pressures, Trends, and Impacts in Coastal Zones: Interactions Between Socioeconomic and Natural Systems*, 20 ENVTL. MANAGEMENT 159, 161 (1996).

[168] A Dutch bank and a member of Lloyd's of London announced the creation of the first catastrophe bond that bundles different natural disaster risks in order to take advantage of this type of diversification. Paul J. Davies, *Catlin and ABN Innovate on Risk*, FIN. TIMES, Nov. 20, 2006.

[169] *See, e.g.*, Philippe Auffret, *Catastrophe Insurance Market in the Caribbean Region: Market Failures and Recommendations for Public Sector Interventions*, WORLD BANK POLICY RESEARCH WORKING PAPER 2963 (2003) (discussing the role reinsurance and capital markets can play in allowing small, island-based insurance companies in the Caribbean to provide hurricane insurance despite intense levels of correlated risk).

Second, a company can diversify risk temporally by pooling risk across a number of years, that is, by establishing a catastrophe reserve to bank premiums against future losses. Furthermore, foreign reinsurance companies not subject to U.S. corporate tax law may be able to accumulate such reserves tax-free, providing temporal diversification through their reinsurance contracts.

B. The Financial Capacity of Private Insurers

A second, related argument for federal intervention is that the private insurance industry lacks the financial "capacity" to offer hurricane insurance given the possible losses from a truly catastrophic series of hurricanes.[170] A spokesperson for the Allstate Corporation stated that, "Our view is that there are some events that have the potential to be so large as to exceed the capabilities of the insurance industry, as well as the funding and financing capability of individual states."[171] In addition, a Florida taskforce has argued that, "Because of the absolute size of the economic losses that are possible due to hurricanes in Florida, the private market, public mechanisms, and even the state itself simply do not have sufficient capacity to provide recovery from a truly mega-catastrophic hurricane event."[172] Upon analysis, none of these claims appears persuasive.

In technical terms, "capacity" refers to the ability of an insurance company to take on risk, or framed another way, to pay claims in the event of a loss.[173] The capacity constraint is largely driven by three things. First, rating agencies like Moody's and Standard & Poor's require insurance companies to maintain a certain level of capital reserves in order to maintain a

[170] *See, e.g.*, September 2006 House Hearing, *supra* note 7, at 87-88 (statement of Gregory W. Heidrich, Property Casualty Insurers Association of America); *id.* at 78-79 (statement of David Daniel, Independent Insurance Agents & Brokers of America); ProtectingAmerica.org website, http://www.protectingamerica.org/?SecID=24.

[171] Joel Garreau, *A Dream Blown Away: Climate Change Already Has a Chilling Effect on Where Americans Can Build Their Homes*, WASH. POST, Dec. 2, 2006, at C1.

[172] TASK FORCE ON LONG-TERM SOLUTIONS FOR FLORIDA'S HURRICANE INSURANCE MARKET, FINAL REPORT [hereinafter FLORIDA TASK FORCE REPORT](2006).

[173] As the Government Accountability Office noted in a 2005 report examining approaches to catastrophe risk, insurance experts do not agree on a precise definition of capacity. GOVERNMENT ACCOUNTABILITY OFFICE, CATASTROPHE RISK: U.S. AND EUROPEAN APPROACHES TO INSURE NATURAL CATASTROPHE AND TERRORISM RISKS, GAO-05-199 at 1, 9 (2005) [hereinafter GAO CATASTROPHE RISK]. However, all agree that capacity roughly defines the ability of the industry to take on risk while still retaining adequate reserves to cover expected losses and protect against insolvency.

favorable credit rating.[174] Second, state insurance regulators enforce complex regulations designed to constrain companies from issuing policies in excess of their capital resources.[175] Finally, an insurance company's interest in corporate self-preservation will presumably discourage it from writing policies that might place it at risk of insolvency.

The capacity argument is contradicted by the fact that the insurance industry has large financial resources that have continued to increase even in the face of recent hurricanes. The private insurance industry reportedly has total worldwide capital of close to $1 trillion.[176] As of December 31, 2005, the surplus of the U.S. insurance industry stood at $439 billion.[177] The reinsurance industry also provides an important and growing backstop for primary insurers. Since Hurricane Katrina, the reinsurance industry raised $26 billion in new capital, with $10.4 billion being invested in startup reinsurance companies.[178]

As a result, the insurance industry has successfully weathered a number of destructive hurricanes in recent years with little financial strain. Indeed, the industry has improved its financial situation markedly since Hurricane Andrew. In the immediate wake of that hurricane, eleven insurance companies became insolvent.[179] A little over a decade later, only one insurance company became insolvent after the 2004 hurricane season[180] and there were no additional insolvencies in the wake of 2005's record-breaking season.[181]

Furthermore, innovative new instruments are being developed that should allow insurance companies to spread risk even further, tapping into the $42 trillion in the world capital market.[182] Two instruments show particular promise, catastrophe bonds and hurricane damage

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[174] April 11, 2007 Senate Banking Committee Hearing, *supra* 79 (statement of Franklin Nutter, Reinsurance Association of America).
[175] *See* JERRY, *supra* note 118, at 118-19.
[176] WORLD BANK, PRIVATE SECTOR & INFRASTRUCTURE SECTOR UNIT, CATASTROPHE RISK MANAGEMENT: USING ALTERNATIVE RISK FINANCING AND INSURANCE POOLING MECHANISMS 21 (2001).
[177] April 11, 2007 Senate Banking Committee Hearing, *supra* note 79 (statement of Franklin Nutter, Reinsurance Association of America).
[178] *Id.*
[179] GAO CATASTROPHE RISK, *supra* note 173, at 6.
[180] *Id.*
[181] RAWLE O. KING, HURRICANE KATRINA: INSURANCE LOSSES AND NATIONAL CAPACITIES FOR FINANCING DISASTER RISK 5 (2005).
[182] WORLD BANK, *supra* note 176, at 21.

contract options.[183] Catastrophe bonds have already generated significant funding for catastrophic event coverage, including $4.5 billion of capacity in 2004 alone. As originally designed, catastrophe bonds were high-risk investments: if no catastrophe occurred the investor received his or her investment back plus significant interest; if a catastrophic event did occur the investment was used to cover losses. In November, 2006, a new type of catastrophe bond was unveiled that bundled together different types of catastrophe risk from around the world, spreading risk more broadly and making this investment vehicle less risky.[184]

A second capital market instrument designed to increase private insurers' capacity is hurricane damage contract options. The Chicago Board of Trade ("CBOT") initially offered options based on a hurricane catastrophe index in the early 1990s. Investors sold option contracts agreeing to make payments to the option holders if the index increased above the strike point. Despite their theoretical appeal, few insurance companies utilized the CBOT instruments, perhaps because of regulatory obstacles, including the fact that some states, as part of their regulation of insurance company investment portfolios, prevented insurance companies from purchasing a sufficient number of options to create an effective hedge.[185] Perhaps because of this constraint, CBOT discontinued offering these contracts.[186] However, in 2006, in response to growing demand for access to the capital markets after the hurricanes of 2004 and 2005, the Chicago Mercantile Exchange started offering a similar instrument.[187]

C. Insurance Affordability

The final argument in favor of federal intervention is that insurance premiums are too high and have risen too fast,[188] harming families, businesses, and the economy as a whole.[189] In

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[183] GAO CATASTROPHE RISK, *supra* note 173, at 26.
[184] Davies, *supra* note 168.
[185] See Kathleen McCullough, *Catastrophe Insurance Futures: Despite Their Value in Hedging Loss, Catastrophe Insurance Futures Issued by the Chicago Board of Trade Face Several Obstacles Before They Can Be Widely Accepted by the Insurance Industry*, 42 RISK MANAGEMENT 31 (1995) for a discussion of different obstacles facing the CBOT futures.
[186] The most recent information CBOT provides for its catastrophe insurance contracts is from 2000. CBOT Website, *ISO Catastrophe Insurance Contracts*, http://www.cbot.com/cbot/docs/72535.pdf (last visited July 25, 2007).
[187] Dow Jones Newswires, *Merc to Offer Hurricane Damage Contracts*, CHICAGO TRIB., Feb. 15, 2007, at C4.
[188] March 2007 House Hearing, *supra* note 79 (Statement of U.S. Representative Ron Klein).

2006, for instance, State Farm sought approval for a 74 percent average premium increase for its hurricane insurance in Florida.[190] Insurance premiums of some businesses in Louisiana have increased by factors of five or even ten.

While consumer alarm at these hefty rate increases is certainly understandable, that does not necessarily mean that rates are too high given the character of the insured risk. One member of Congress recently acknowledged the risks involved in living in areas facing high hurricane premiums, "I can tell you, in my own State of Florida, that there is not one square inch of Florida that has not been devastated by some hurricane over the last 2 years."[191] Is it any wonder that insurance companies charge hefty premiums to provide insurance in a state so frequently hit by hurricanes?

From a broader social welfare perspective, high insurance rates that reflect the risks of living in coastal areas are appropriate because they require property owners to internalize the costs of their decisions. By contrast, a government policy to promote the "affordability" of coastal insurance sends the wrong signal, encouraging investment in hazardous areas.

To some degree, the sharp increases in insurance rates, and the resulting public outcry, represent transitory responses to the major hurricanes of 2004 and 2005. Changes in hurricane models, credit rating practices, and reductions in reserves led insurance companies to increase their premiums and, in some cases, withdraw from sectors of the market. Over the longer term, however, as capital reserves are replenished, and new companies enter the market in order to profit from increases in premiums, insurance rates should stabilize. For instance, during the last two years, new companies have entered the Florida property market, arguably the market most at risk from hurricanes; between October 2004 and January 2006, the Florida Office of Insurance Regulation licensed sixteen new companies to sell property insurance.[192]

In weighing the argument for federal intervention, there is a reasonable basis for distinguishing between long-time property owners and new development. Homeowners and business owners, through no fault of their own, may have purchased property in hazardous

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[189] May 2007 House Hearing, *supra* note 80 (statement of Mike Kreidler, Washington State Insurance Commissioner); March 2007 House Hearing, *supra* note 79 (statement of Gary Thomas, National Association of Realtors).
[190] Waddell, *supra* note 14.
[191] *Id.* at 14 (statement of Representative Clay Shaw).
[192] FLORIDA TASK FORCE REPORT, *supra* note 172, at 35.

coastal areas in the past based on widespread underestimates of the risks involved. Congress could decide to soften the financial burden from insurance rate hikes on these long-time owners just as Congress sometimes provides direct grants to other citizens in need of assistance. Low- and moderate-income families are obviously most vulnerable to the effects of insurance rate hikes. On the other hand, developers and prospective new residents stand in a very different position. Those who are considering moving into hazardous coastal areas are on notice of the risks associated with hurricanes and global warming, and of the insurance rates that accompany such risks. Artificially reducing their insurance rates would encourage disregard for the public and private costs of unwise land use decision making and cannot be justified by considerations of fairness.

Thus, while requiring property owners to bear the full cost of obtaining insurance against hurricanes is generally the most efficient policy, Congress could decide that high premiums impose too great a financial burden on some coastal residents. To address this problem, while minimizing distortions to the insurance market, relief could be provided in the form of direct subsidies rather than through either adjustments in insurance rates or broad government-run insurance programs. This approach would ensure that the price signals provided by insurance policies would be widely broadcast, while minimizing their impact on certain segments of the population. It would also allow Congress to fully debate the public cost of helping coastal residents in light of its broader budgetary priorities. Finally, by creating a tailored, direct-subsidy program, Congress would reduce the risk that insurance regulations would be hijacked in the future by those seeking broader subsidies for coastal development, including new construction. To achieve its narrow purpose, this type of subsidy should be non-transferable and limited to those currently living in pre-existing structures.

VII. UNINTENDED CONSEQUENCES OF INTERVENTION

Not only have advocates failed to make a strong affirmative case for federal intervention in the hurricane insurance business, but such action could have a variety of harmful unintended consequences.

A. Large Potential Liability for Federal Taxpayers

A federal hurricane insurance program could be extremely expensive for taxpayers. Moreover, depending on how such a program were structured, the actual cost of such a program

might not be apparent for many years, By providing multi-peril insurance or catastrophic reinsurance, the federal government would accept liability for future events in exchange for current premium payments. The extent of the subsidy provided by taxpayers would only become clear when one or more catastrophic storms occurred.

The NFIP illustrates this problem. Between 1985 and 2005, the NFIP was financially self-supporting.[193] In some years losses exceeded premiums and the program borrowed money from the federal treasury, and in other years the premiums exceeded losses and the program paid off its debts.[194] Throughout this period, however, the program failed to accumulate reserves in anticipation of an extreme flood year. In order to cover its losses from the 2005 hurricane season, the NFIP may have to borrow over $24 billion from the federal treasury,[195] and the program is widely believed to be incapable of repaying its debt.[196] If Congress eventually forgives much or all of the NFIP debt, it will transform the program's failure to adequately price flood insurance into a direct government subsidy.

There is little reason to believe that federal multi-peril insurance would not similarly fail to generate premiums sufficient to cover losses from extreme hurricane years. Given the fact that the United States is experiencing accelerating hurricane losses, the potential for taxpayer liability is enormous. Federal catastrophe reinsurance poses a similar, albeit somewhat more limited danger. Unlike the proposed multi-peril insurance program, which would presumably be widely available to those living along the coasts, both of the current proposals to create federal reinsurance would cap federal liability ($200 billion for HIPA and $25 billion for HIAA), limiting to some degree the exposure of future taxpayers.

The taxpayer expenditures associated with these hurricane programs would likely be shielded from serious public review. Because both multi-peril insurance and reinsurance would impose potential future liabilities, they would not require congressional appropriations during most years and might not require budget offsets under pay-as-you-go rules at the time of their

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[193] King I, *supra* note 48, at 5 tbl. 1. Prior to 1985, Congress appropriated money to cover NFIP debt.
[194] *Id.* at 4-5.
[195] Letter from Donald B. Marron, Acting Director, Congressional Budget Office, to Congressman Judd Gregg at 2 (May 31, 2006) [hereinafter Marron Letter], *available at* http://www.cbo.gov/ftpdocs/72xx/doc7233/05-31-NFIPLetterGregg.pdf.
[196] *See, e.g.*, Marron Letter, *supra* note 195, at 1; GAO HIGH-RISK SERIES UPDATE, *supra* note 195, at 91; KING I, *supra* note 48, at 5.

creation. Thus, despite directly competing with future funding for other government programs, each would escape consideration during the budget process. By the time program short falls are realized, it would be too late. Much like the NFIP, these insurance programs might borrow substantial amounts from the federal treasury in order to pay claims with no ability repay the debt, necessitating large congressional appropriations in the wake of severe hurricane seasons.

B. Unfair Subsidies

Federal intervention could result in significant, unfair public subsidies for those who make the hazardous choice to construct or maintain a home or business in a coastal area.

Those that live in the most hurricane-prone areas already receive subsidized insurance rates. Private insurers create some degree of cross-subsidy across different property owners by using average premium rates for particular geographic areas. Federal and state governments directly subsidize premiums for many coastal homeowners. For example, the NFIP provides subsidized insurance to protect against storm surge and other floods and both of Florida's primary insurance programs impose assessments against other lines of private insurance to make up program deficits,[197] forcing the holders of automobile or medical malpractice insurance to pay some of the cost of insuring coastal property owners.[198]

Proposals for expanded federal intervention in the insurance business could greatly increase the level of subsidy if the government failed to charge a fully risk-adjusted rate. These subsidies would be unfair because they would force those who have chosen to live in relatively safe locations, like rural homeowners in Michigan, to pay for the risky decisions of those who have elected to live in or operate businesses in more hazard-prone areas, like beachfront property owners in Florida. In addition, these subsidies would likely result in unfair wealth transfers from the general taxpayer to the relatively affluent. This is not to say that all residents of high-risk property are wealthy; Hurricane Katrina made abundantly clear that many low-income people live in the danger zone. But real estate values and wealth tend to increase dramatically as one approaches the ocean shore.

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[197] MILLIMAN CONSULTANTS AND ACTUARIES, ANALYSIS OF FLORIDA LEGISLATIVE REFORM: SPECIAL SESSION, JANUARY 2007 15-16 (2007).
[198] *See id.*

C. Displacing Private Enterprise

Another predictable adverse effect of federal intervention in the coastal insurance market is that it would tend to drive out private insurers, eliminating the market discipline imposed by the profit motive. This would occur because private companies cannot effectively compete in the marketplace if the government is offering insurance at subsidized rates.

The NFIP illustrates the crowding-out effect of a government insurance program. In the early twentieth century, private insurance companies provided flood insurance. After a series of disastrous floods along the Mississippi River, Congress began debating a plan to create a federal flood insurance program, which resulted in the NFIP.[199] In other countries that have chosen not to create a government flood insurance program, private companies continue to provide coverage for flood risk.[200] It seems plausible that, had the federal government not interceded, the United States would also enjoy the benefits of private flood insurance. However, with a federal program in place, private insurance companies have all but abandoned the field.

Displacing private insurers from the business of insuring against wind damage from hurricanes would have several potentially serious drawbacks. Without a private market for reference, setting public insurance premiums could become a purely political exercise. This would create the risk that, over time, motivated and well-organized interest groups could agitate for lower rates, increasing the public subsidy they receive.

Second, market pressure creates incentives for private insurance companies to operate efficiently and seek lower-cost ways of administering their products. Without this motivation, a federal insurance program is likely to be economically wasteful.

Finally, on a longer term basis, displacing private enterprise reduces the likelihood that new and more effective insurance strategies will emerge to help cope with hurricane losses. As discussed, innovative financial instruments for spreading disaster risks, such as catastrophic bonds, are rapidly evolving. Government intervention may stifle the development of these new financial instruments.

[199] *See* Scales, *supra* note 39, at 7-8.
[200] *See, e.g.*, SWISS RE II, *supra* note 37.

D. Increasing Hurricane Vulnerability

Federal intervention would increase the vulnerability of coastal areas and their residents to future hurricanes and other storms. By further relieving local governments of financial responsibility for hurricane damage, a federal program could encourage inefficient land use planning and undermine efforts to impose building codes and other mitigation requirements. As discussed previously, many commentators believe that the NFIP has encouraged local governments to leave floodplains largely unregulated because the federal government has assumed financial responsibility for flood losses.

To the extent federal intervention constrained insurance premiums, it would reduce the cost of coastal development and thereby increase its pace and scope. In other words, insurance rates that do not reflect the actual level of risk result in an economically inefficient level of development. Moreover, more development along the coast would only increase the concentration of valuable property subject to the risk of hurricane damage.

By encouraging new coastal development, a federal hurricane insurance program could increase the vulnerability of already existing coastal structures. Dunes and salt marshes provide defenses against storm surges caused by hurricanes, and coastal vegetation provides some relief from intense winds. As global warming causes sea level to rise, an increasing number of people will be at risk from storm surges, making remaining natural defenses all the more important. Development of these natural areas reduces or eliminates their effectiveness as storm defenses, increasing the vulnerability of neighboring properties.

Encouraging more people to live along the shore has moral implications as well. Subsidized insurance may lull citizens into a false sense of security, imperiling themselves and their families.

Finally, subsidizing the risks associated with hurricanes has the potential to create an addictive, vicious cycle.[201] If government provides such subsidies, more people will move into

[201] Rutherford H. Platt notes that political pressure to federalize flood insurance and create broad disaster relief for those in flood plains grew out of federal polices that encouraged growth in those hazardous areas, including Veterans Administration loan policies, the federal highway system, and tax policies that encouraged home building. Federal largess for those that built in flood plains created a perceived need to provide low-cost flood insurance. In Professor Platt's words, "In the process, an implicit new social compact was gradually forged between

hazardous areas. This would lead to an ever-expanding constituency for government subsidized insurance, and ultimately more vulnerability to hurricanes and other storms.

Insurance premiums that reflect the actual nature of the covered risk can inform consumers and investors about the hazards they face.[202] In this fashion, insurance can help individuals make good decisions about where they wish to live, restrain inefficient development, and help stabilize the United States' vulnerability to hurricanes. To the extent a federal program interferes with these salutary functions of the insurance system, it would exacerbate the United States' hurricane vulnerability.

E. Destruction of Ecologically Important Areas

Finally, federal intervention in the market for hurricane insurance would harm the environment by encouraging the destruction of ecologically fragile areas. Such areas, which are already becoming increasingly scarce, are a valuable natural resource, providing vital habitat to 45 percent of the endangered and threatened species in the United States.[203]

Extensive development in the coastal zone has already led to serious environmental losses. The U.S. Fish and Wildlife Service estimates that between the mid-1970s and 2004, the coastal United States lost, in net, over 157,000 acres of saltwater wetland and beaches.[204] This estimate is likely to understate the damage because it offsets the destruction of natural wetlands with newly created wetlands,[205] an effort that, in many cases, has only debatable value.[206]

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government and citizenry in which the former assumed a large share of disaster losses arising from the bad luck or bad judgment of the latter." PLATT, *supra* note 132, at 11.

[202] *See* CONGRESSIONAL RESEARCH SERVICE, A DESCRIPTIVE ANALYSIS OF FEDERAL RELIEF, INSURANCE, AND LOSS REDUCTION PROGRAMS FOR NATURAL HAZARDS 33 (1994).

[203] THOMAS E. DAHL, STATUS AND TRENDS OF WETLANDS IN THE CONTERMINOUS UNITED STATES 1986 TO 1997 35 (U.S. Fish and Wildlife Service 2000) [hereinafter STATUS & TRENDS OF WETLANDS 2000].

[204] The majority (118,900 acres) of this loss occurred between the mid-1970s to mid-1980s. THOMAS E. DAHL & CRAIG E. JOHNSON, WETLANDS: STATS AND TRENDS IN THE CONTERMINOUS UNITED STATES MID-1970'S TO MID-1980'S 10 (U.S. Fish and Wildlife Service 1991). 10,400 acres were lost between 1986 and 1997, STATUS & TRENDS OF WETLANDS 2000, *supra* note 203, at 30, and 28,416 acres were lost between 1998 and 2004. THOMAS E. DAHL, STATUS AND TRENDS OF WETLANDS IN THE CONTERMINOUS UNITED STATES 1998 TO 2004 48 (U.S. Fish & Wildlife Service, 2006) [hereinafter STATUS & TRENDS OF WETLANDS 2006].

[205] *See* STATUS & TRENDS OF WETLANDS 2006, *supra* note 204, at 7.

[206] *See, e.g.*, Craig Pittman & Matthew Waite, *Mitigation: A Solution or Just Absolution?*, ST. PETERSBURG TIMES, May 23, 2005, at 5A (describing a failed wetland creation projects in Florida).

Florida alone lost over 84,000 acres of fresh and saltwater wetlands between the late 1980s and 2003,[207] and a scientist with the U.S. Geologic Survey suggests that Louisiana, which houses more than 40 percent of the tidal wetlands in the continental United States, loses over 24,700 acres each year.[208] Making coastal development more profitable by subsidizing insurance would increase the development pressure on the natural areas that remain.

The prospect of global warming increases the importance of avoiding policies that would destroy remaining coastal natural areas. As sea level rises, remaining salt marshes, estuaries, mangroves, and other coastal wetlands will be threatened. Scientists estimate that a one-meter rise in sea level could itself destroy more than 6,500 square miles,[209] or as much as half,[210] of remaining U.S. coastal wetlands.

VIII. RECOMMENDATIONS

Wise public policy counsels against major federal government intervention in the business of coastal insurance. Advocates for pending proposals before Congress have failed to demonstrate that these policies respond to any genuine need, and they would have harmful unintended consequences. Nonetheless, there are a handful of targeted reforms worth considering.

A. Government-Generated Information

The federal government could play a useful role by generating detailed information about the types of risks different properties face from hurricanes, including producing hazard maps that identify wind risks based on such factors as proximity to the ocean, local topography, and vegetation.

Insurance companies have only limited economic incentive to set individual insurance rates based on the risk characteristics of each property. On the other hand, tailored insurance rates would create a public good by providing consumers more detailed information about the risks associated with different living and business choices and dissuading investors from

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[207] Craig Pittman & Matthew Waite, *Satellite Photographs Show Losses*, ST. PETERSBURG TIMES, at National Sec. 11A (May 22, 2005).
[208] S. JEFFRESS WILLIAMS ET AL., COASTS IN CRISIS ONLINE VERSION (U.S. Geological Survey 1997), http://pubs.usgs.gov/circ/c1075/intro.html#fig2.
[209] Turner et al., *supra* note 167, at 163.
[210] Nicholls, *supra* note 30, at 71.

purchasing and developing high-hazard properties. Thus, there may be a role for government in generating more fine-grained hazard information than insurance companies would generate on their own.

Government has played a similar role in the past. In conjunction with the initial effort to use state FAIR Plans to increase the availability of property insurance in urban areas in the 1960s, some states created programs to provide insurance companies with detailed information about the risks facing individual properties.[211] While this information would have been too costly for the insurance industry to gather on its own, it made it easier for private insurers to quantify the risks facing properties in urban areas and to decide whether or not to provide coverage.

If the government embarks on such a program, the goal should be to provide more accurate, up-to-date information than is currently contained in NFIP flood maps. Insurance companies would have a powerful incentive to ensure that this occurs and could provide supportive feedback to both Congress and the public based on their experience using the maps or other information.

B. Mandatory Wind Coverage

States should consider requiring coastal owners who are vulnerable to hurricanes to carry hurricane insurance, [212] just as most states require automobile owners to carry some level of insurance,[213] and Massachusetts now requires all residents to carry health insurance.[214] As discussed, for a variety of understandable psychological reasons, property owners tend to discount low-probability hazards and therefore fail to obtain insurance even though it would be economically rational for them to do so. A mandatory insurance requirement would overcome these psychological obstacles and have a number of other advantages, including (1) increasing the number of low-risk property owners in hurricane zones carrying insurance, (2) improving

[211] Dwyer, *supra* note 70, at 621.
[212] *C.f.* SWISS RE III, *supra* note 126, at 32 (recommending mandatory flood insurance requirement to better spread risk).
[213] JERRY, *supra* note 118, at 122. In some states, car owners can avoid the insurance requirement by demonstrating that they have the financial ability to pay for any injury.
[214] Under the Massachusetts law, all state residents must purchase insurance by July 1, 2007 or risk financial penalties. Scott Helman, *Mass. Bill Requires Health Insurance*, BOSTON GLOBE, Apr. 4, 2006 at A1; Pam Belluck & Katie Lezima, *Massachusetts Legislation on Insurance Becomes Law*, N.Y. TIMES, Apr. 13, 2006 at A13.

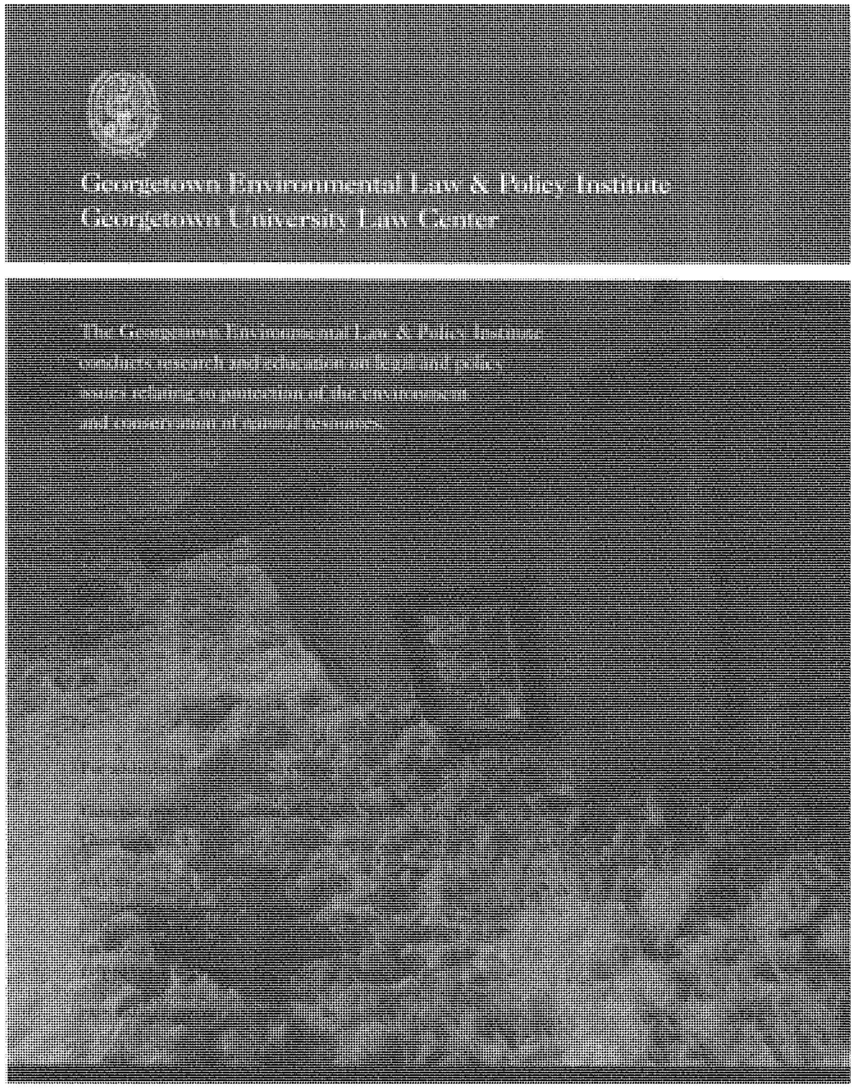
companies' ability to spread risk, (3) minimizing market disruptions caused by abrupt changes in consumer demand for insurance coverage caused by high-profile disasters, (4) reducing future political demands for federal disaster relief that includes compensation for property losses by uninsured owners, and (5) compelling all property owners to pay attention to the market signals regarding risk provided by insurance premiums.

C. Phasing Out the NFIP and Replacing It with Private Multi-Peril Insurance

Congress should consider phasing out the NFIP in favor of private insurance over time. The NFIP has been a public policy disaster for a number of reasons, and the current distinction between wind damage and water damage is confusing to the public and unworkable in practice. While this proposal would undoubtedly upset many vested interests, it is neither novel nor radical. A former Federal Insurance Administrator testified before Congress that the time has come to reconsider the federal government's role in providing flood insurance. The change could be phased in through a public/private partnership in which the federal government would agree to provide reinsurance to private insurance companies to absorb catastrophic flood losses until the private market has matured. The federal government also might have a continuing, more productive role to play in creating flood maps; while the NFIP has not succeeded in the past in maintaining up-to-date flood maps, the watchful oversight of private insurance companies relying on the maps could improve the situation.

D. Private Insurance Catastrophe Funds

Eliminating taxation of insurance premiums that companies devote to reserve funds to pay for catastrophic losses appears to be a promising way of increasing the capacity of the private sector without distorting the insurance market. As discussed, current tax policy makes hurricane insurance, which requires high levels of surplus, relatively more costly for insurance companies to provide than other forms of insurance. A change in the law that allowed insurers to bank premiums against future expected hurricane losses would level the playing field and expand capacity for hurricane insurance. However, if Congress pursues such a policy, it should take care to avoid creating an opportunity for insurance companies to use catastrophe funds as a tax avoidance device. This could be accomplished by requiring that distributions from the fund be used exclusively to pay insured losses.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In Nature's Casino

By MICHAEL LEWIS

It was Aug. 24, 2005, and New Orleans was still charming. Tropical Depression 12 was spinning from the Bahamas toward Florida, but the chances of an American city's being destroyed by nature were remote, even for one below sea level. An entire industry of weather bookies — scientists who calculate the likelihood of various natural disasters — had in effect set the odds: a storm that destroys $70 billion of insured property should strike the United States only once every 100 years. New Orleanians had made an art form of ignoring threats far more likely than this; indeed, their carelessness was a big reason they were supposedly more charming than other Americans. And it was true: New Orleanians found pleasure even in oblivion. But in their blindness to certain threats, they could not have been more typically American. From Miami to San Francisco, the nation's priciest real estate now faced beaches and straddled fault lines; its most vibrant cities occupied its most hazardous land. If, after World War II, you had set out to redistribute wealth to maximize the sums that might be lost to nature, you couldn't have done much better than Americans had done. And virtually no one — not even the weather bookies — fully understood the true odds.

But there was an exception: an American so improbably prepared for the havoc Tropical Depression 12 was about to wreak that he might as well have planned it. His name was John Seo, he was 39 years old and he ran a hedge fund in Westport, Conn., whose chief purpose was to persuade investors to think about catastrophe in the same peculiar way that he did. He had invested nearly a billion dollars of other people's money in buying what are known as "cat bonds." The buyer of a catastrophe bond is effectively selling catastrophe insurance. He puts down his money and will lose it all if some specified bad thing happens within a predetermined number of years: a big hurricane hitting Miami, say, or some insurance company losing more than $1 billion on any single natural disaster. In exchange, the cat-bond seller — an insurance company looking to insure itself against extreme losses — pays the buyer a high rate of interest.

Whatever image pops to mind when you hear the phrase "hedge fund manager," Seo (pronounced so) undermines it. On one hand, he's the embodiment of what Wall Street has become: quantitative. But he's quirky. Less interested in money and more interested in ideas than a Wall Street person is meant to be. He inherited not money but math. At the age of 14, in 1950, his mother fled North Korea on foot, walked through live combat, reached the United States and proceeded to become, reportedly, the first Korean woman ever to earn a Ph.D. in mathematics. His father, a South Korean, also came to the United States for his Ph.D. in math and became a professor of economic theory. Two of his three brothers received Ph.D.'s — one in biology, the other in electrical engineering. John took a physics degree from M.I.T. and applied to Harvard to study for his Ph.D. As a boy, he says, he conceived the idea that he would be a biophysicist, even though he didn't really know what that meant, because, as he puts it, "I wanted to solve a big problem about life." He earned his doctorate in biophysics from Harvard in three years, a department record.

His parents had raised him to think, but his thoughts were interrupted once he left Harvard. His wife was

pregnant with their second child, and the health plan at Brandeis University, where he had accepted a job, declared her pregnancy a pre-existing condition. He had no money, his parents had no money, and so to cover the costs of childbirth, he accepted a temp job with a Chicago trading firm called O'Connor and Associates. O'Connor had turned a small army of M.I.T. scientists into options traders and made them rich. Seo didn't want to be rich; he just wanted health insurance. To get it, he agreed to spend eight weeks helping O'Connor price esoteric financial options. When he was done, O'Connor offered him 40 grand and asked him to stay, at a starting salary of $250,000, 27 times his post-doc teaching salary. "Biophysics was starved for resourees," Seo says. "Finance was hurling resources at problems. It was almost as if I was taking it as a price signal. It was society's way of saying, Please, will you start solving problems over here?"

His parents, he suspected, would be appalled. They had sacrificed a lot for his academic career. In the late 1980s, if you walked into the Daylight Donuts shop in Dallas, you would have found a sweet-natured Korean woman in her early 50s cheerfully serving up honey-glazed crullers: John's mom. She had abandoned math for motherhood, and then motherhood for doughnuts, after her most promising son insisted on attending M.I.T. instead of S.M.U., where his tuition would have been free. She needed money, and she got it by buying this doughnut shop and changing the recipe so the glaze didn't turn soggy. (Revenues tripled.) Whatever frustration she may have felt, she hid, as she did most of her emotions. But when John told her that he was leaviug the university for Wall Street, she wept. His father, a hard man to annoy, said, "The devil has come to you as a prostitute and has asked you to lie down with her."

A willingness to upset one's mother is usually a promising first step to a conventional Wall Street career. But Seo soon turned Wall Street into his own private science lab, and his continued interest in deep questions mollified even his father. "Before he got into it, I strongly objected," Tae Kun Seo says. "But now I think he's not just grabbing money." He has watched his son quit one firm to go to work for another, but never for a simple promotion; instead, John has moved to learn something new. Still, everywhere he goes, he has been drawn to a similar thorny problem: the right price to charge to insure against potential losses from extremely unlikely financial events. "Tail risk," as it is known to quantitative traders, for where it falls in a bell-shaped probability curve. Tail risk, broadly speaking, is whatever financial cataclysm is believed by markets to have a 1 percent chance or less of happening. In the foreign-exchange market, the tail event might be the dollar falling by one-third in a year; in the bond market, it might be interest rates moving 3 percent in six months; in the stock market, it might be a 30 percent crash. "If there's been a theme to John's life," says his brother Nelson, "it's pricing tail."

And if there has been a theme of modern Wall Street, it's that young men with Ph.D.'s who approach money as science can cause more trouble than a hurricane. John Seo is oddly sympathetic to the complaint. He thinks that much of the academic literature about finance is nonsense, for instance. "These academics couldn't understand the fact that they couldn't beat the markets," he says. "So they just said it was efficient. And, 'Oh, by the way, here's a ton of math you don't understand.' " He notes that smart risk-takers with no gift for theory often end up with smart solutions to taking extreme financial risk — answers that often violate the academic theories. ("The markets are usually way ahead of the math.") He prides himself on his ability to square book smarts with horse sense. As one of his former bosses puts it, "John was known as the man who could price anything, and his pricing felt right to people who didn't understand his math."

In the mid-1990s, when Wall Street first noticed money to be made covering the financial risks associated

with hurricanes and earthquakes, it was inevitable that someone would call John Seo to ask him if he could figure out how to make sense of it. Until then, he had specialized in financial, not natural, disasters. But there was a connection between financial catastrophe and natural catastrophe. Both were extreme, both were improbable and both needed to be insured against. The firm that called him was Lehman Brothers, whose offer enticed Seo to quit his job and spend his first year at Lehman learning all he could about the old-fashioned insurance industry.

Right away, he could see the problem with natural catastrophe. An insurance company could function only if it was able to control its exposure to loss. Geico sells auto insurance to more than seven million Americans. No individual car accident can be foreseen, obviously, but the total number of accidents over a large population is amazingly predictable. The company knows from past experience what percentage of the drivers it insures will file claims and how much those claims will cost. The logic of catastrophe is very different: either no one is affected or vast numbers of people are. After an earthquake flattens Tokyo, a Japanese earthquake insurer is in deep trouble: millions of customers file claims. If there were a great number of rich cities scattered across the planet that might plausibly be destroyed by an earthquake, the insurer could spread its exposure to the losses by selling earthquake insurance to all of them. The losses it suffered in Tokyo would be offset by the gains it made from the cities not destroyed by an earthquake. But the financial risk from earthquakes — and hurricanes — is highly concentrated in a few places.

There were insurance problems that were beyond the insurance industry's means. Yet insurers continued to cover them, sometimes unenthusiastically, sometimes recklessly. Why didn't insurance companies see this? Seo wondered, and then found the answer: They hadn't listened closely enough to Karen Clark.

Thirteen years before what would become Tropical Storm Katrina churned toward Florida — on Monday, Aug. 24, 1992 — Karen Clark walked from her Boston office to a nearby Au Bon Pain. Several hours earlier, Hurricane Andrew had struck Florida, and she knew immediately that the event could define her career. Back in 1985, while working for an insurance company, Clark wrote a paper with the unpromising title "A Formal Approach to Catastrophe Risk Assessment in Management." In it, she made the simple point that insurance companies had no idea how much money they might lose in a single storm. For decades Americans had been lurching toward catastrophe. The 1970s and '80s were unusually free of major storms. At the same time, Americans were cramming themselves and their wealth onto the beach. The insurance industry had been oblivious to the trends and continued to price catastrophic risk just as it always had, by the seat of its pants. The big insurance companies ran up and down the Gulf Coast selling as many policies as they could. No one — not even the supposed experts at Lloyd's of London — had any idea of the scope of new development and the exposure that the insurance industry now had.

To better judge the potential cost of catastrophe, Clark gathered very long-term historical data on hurricanes. "There was all this data that wasn't being used," she says. "You could take it, and take all the science that also wasn't being used, and you could package it in a model that could spit out numbers companies could use to make decisions. It just seemed like such an obvious thing to do." She combined the long-term hurricane record with new data on property exposure — building-replacement costs by ZIP code, engineering reports, local building codes, etc. — and wound up with a crude but powerful tool, both for judging the probability of a catastrophe striking any one area and for predicting the losses it might inflict. Then she wrote her paper about it.

The attention Clark's paper attracted was mostly polite. Two years later, she visited Lloyd's — pregnant with her first child, hanling a Stone Age laptop — and gave a speech to actual risk-takers. In nature's casino, they had set themselves up as the house, and yet they didn't know the odds. They assumed that even the worst catastrophe could generate no more than a few billion dollars in losses, but her model was generating insured losses of more than $30 billion for a single storm — and these losses were far more likely to occur than they had been in the previous few decades. She projected catastrophic storms from the distant past onto the present-day population and storms from the more recent past onto richer and more populated areas than they had actually hit. (If you reran today the hurricane that struck Miami in 1926, for instance, it would take out not the few hundred million dollars of property it destroyed at the time but $60 billion to $100 billion.) "But," she says, "from their point of view, all of this was just in this computer."

She spoke for 45 minutes but had no sense that she had been heard. "The room was very quiet," she says. "No one got up and left. But no one asked questions either. People thought they had already figured it out. They were comfortable with their own subjective judgment." Of course they were; they had made pots of money the past 20 years insuring against catastrophic storms. But — and this was her real point — there hadn't been any catastrophic storms! The insurers hadn't been smart. They had been lucky.

Clark soon found herself in a role for which she was, on the surface at least, ill suited: fanatic. "I became obsessed with it," she says. One big player in the insurance industry took closer notice of her work and paid her enough to start a business. Applied Insurance Research, she called it, or A.I.R. Clark hired a few scientists and engineers, and she set to work acquiring more and better data and building better models. But what she really was doing — without quite realizing it — was waiting, waiting for a storm.

Hurricane Andrew made landfall at 5 on a Monday morning. By 9 she knew only the path of the storm and its intensity, but the information enabled her to estimate the losses: $13 billion, give or take. If builders in South Florida had ignored the building codes and built houses to lower standards, the losses might come in even higher. She faxed the numbers to insurers, then walked to Au Bon Pain. Everything was suddenly more vivid and memorable. She ordered a smoked-turkey and Boursin cheese sandwich on French bread, with lettuce and tomato, and a large Diet Coke. It was a nice sunny day in Boston. She sat outside at a small black table, alone. "It was too stressful to be with other people," she says. "I didn't want to even risk a conversation." She ate in what she describes as "a catatonic state." The scuttlebutt from Lloyd's already had it that losses couldn't possibly exceed $6 billion, and some thought they were looking at a loss of just a few hundred million. "No one believed it," she says of her estimate. "No one thought it was right. No one said, 'Yeah, $13 billion sounds like a reasonable number.' " As she ate, she wondered what $13 billion in losses looked like.

When she returned to the office, her phones were ringing. "People were outraged," she says. "They thought I was crazy." One insurance guy called her, chortling. "A few mobile homes and an Air Force base — how much could it be?" he said.

It took months for the insurers to tote up their losses: $15.5 billion. (Building codes in South Florida had not been strictly enforced.) Fifteen and a half billion dollars exceeded all of the insurance premiums ever collected in Dade County. Eleven insurance companies went bust. And this wasn't anything like the perfect storm. If it had gone into Miami, it could have bankrupted the whole industry. Clark had been right: the potential financial losses from various catastrophes were too great, and too complicated, to be judged by

human intuition. "No one ever called to congratulate me," Clark says, laughing. "But I had a lot of people call and ask to buy the model."

After Hurricane Andrew came a shift in the culture of catastrophe. "This one woman really created the method for valuing this risk," says John Seo. Clark's firm, A.I.R., soon had more than 25 Ph.D.'s on staff and two competitors, Eqecat and Risk Management Solutions. In its Bay Area offices, R.M.S. now houses more than 100 meteorologists, seismologists, oceanographers, physicists, engineers and statisticians, and they didn't stop at hurricanes and earthquakes but moved on to flash floods, wildfires, extreme winter storms, tornadoes, tsunamis and an unpleasant phenomenon delicately known as "extreme mortality," which, more roughly speaking, is the possibility that huge numbers of insured human beings will be killed off by something like a global pandemic.

The models these companies created differed from peril to peril, but they all had one thing in common: they accepted that the past was an imperfect guide to the future. No hurricane has hit the coast of Georgia, for instance, since detailed records have been kept. And so if you relied solely on the past, you would predict that no hurricane ever will hit the Georgia coast. But that makes no sense: the coastline above, in South Carolina, and below, in Florida, has been ravaged by storms. "You are dealing with a physical process," says Robert Muir-Wood, the chief scientist for R.M.S. "There is no physical reason why Georgia has not been hit. Georgia's just been lucky." To evaluate the threat to a Georgia beach house, you need to see through Georgia's luck. To do this, the R.M.S. modeler creates a history that never happened: he uses what he knows about actual hurricaues, plus wbat he knows about the forces that create and fuel hurricanes, to invent a 100,000-year history of hurricanes. Real history serves as a guide — it enables him to see, for instance, that the odds of big hurricanes making landfall north of Cape Hatteras are far below the odds of them striking south of Cape Hatteras. It allows him to assign different odds to different stretches of coastline without making the random distinctions that actual hurricanes have made in the last 100 years. Generate a few hundred thousand hurricanes, and you generate not only dozens of massive hurricanes that hit Georgia but also a few that hit, say, Rhode Island.

The companies' models disagreed here and there, but on one point they spoke with a single voice: four natural perils had outgrown the insurers' ability to insure them — U.S. hurricane, California earthquake, European winter storm and Japanese earthquake. The insurance industry was prepared to lose $30 billion in a single event, once every 10 years. The models showed that a sole hurricane in Florida wouldn't have to work too hard to create $100 billion in losses. There were concentrations of wealth in the world that defied the logic of insurance. And most of them were in America.

The more John Seo looked into the insurance industry, the more it seemed to be teetering at the edge of ruin. This had happened once before, in 1842, when the city of Hamburg burned to the ground and bankrupted the entire German insurance industry many times over. Out of the ashes was born a new industry, called reinsurance. The point of reinsurance was to take on the risk that the insurance industry couldn't dilute through diversification — say, the risk of an entire city burning to the ground or being wiped off the map by a storm. The old insurance companies would still sell policies to the individual residents of Hamburg. But they would turn around and hand some of the premiums they collected to Cologne Re (short for reinsurance) in exchange for taking on losses over a certain amount. Cologne Re would protect itself by diversifying at a higher level — by selling catastrophic fire insurance to lots of other towns.

But by their very nature, the big catastrophic risks of the early 21st century couldn't be diversified away. Wealth had become far too concentrated in a handful of extraordinarily treacherous places. The only way to handle them was to spread them widely, and the only way to do that was to get them out of the insurance industry and onto Wall Street. Today, the global stock markets are estimated at $59 trillion. A 1 percent drop in the markets — not an unusual event — causes $590 billion in losses. The losses caused by even the biggest natural disaster would be a drop in the bucket to the broader capital markets. "If you could take a Magnitude 8 earthquake and distribute its shock across the planet, no one would feel it," Seo says. "The same principle applies here." That's where catastrophe bonds came in: they were the ideal mechanism for dissipating the potential losses to State Farm, Allstate and the other insurers by extending them to the broader markets.

Karen Clark's model was, for Seo, the starting point. When he first stumbled upon it and the other companies' models, he found them "guilty until proven innocent," as he puts it. "I could see the uncertainty in them," he says, "just by looking at the different numbers they generated for the same storm." When they run numbers to see what would happen if the 1926 Miami hurricane hit the city today, A.I.R. puts the losses at $80 billion, R.M.S. at $106 billion and Eqecat at $63 billion. They can't all be right. But they didn't need to be exactly right, just sort of right, and the more he poked around inside them, the more he felt they were better than good enough to underpin financial decisions. They enabled you to get a handle on the risk as best you could while acknowledging that you would never know it exactly. And after all, how accurate were the models that forecast the likelihood that Enron would collapse? Next to what Wall Street investors tried to predict every day, natural disasters seemed almost stable. "In the financial markets, you have to care what other people think, even if what they think is screwed up," Seo says. "Crowd dynamics build on each other. But these things — hurricanes, earthquakes — don't exhibit crowd behavior. There's a real underlying risk you have to understand. You have to be a value investor."

The models were necessary but insufficient. True, they gave you a rough sense of the expected financial losses, but they said nothing about the rewards. Financial markets exist only as long as investors feel the odds are stacked in their favor. Investors — unlike roulette players — can honestly expect to make a gain (their share in the profits of productive enterprise). But how big a gain? How should the payout vary, from government bonds to blue-chip stocks to subprime mortgages? The rewards in each market tended to vary with investors' moods, but those in catastrophe insurance were just incredibly volatile. Hurricane insurance rates would skyrocket after a big storm, then settle back down. This wouldn't do: if big investors were going to be persuaded to take billions of dollars in catastrophic risk, they would need to feel there was some reason in the pricing of that risk. "The market," as Seo puts it, "needs an acceptable mode of failure."

In the spring of 2001, to the surprise of his colleagues, Seo left his big Wall Street firm and opened a hedge fund — which, he announced, wouldn't charge its investors the standard 2 percent of assets and 20 percent of returns but a lower, flat fee. "It was quixotic," says Paul Puleo, a former executive at Lehman who worked with Seo. "He quits this high-paying job to basically open a business in his garage in a market that doesn't exist." Seo opened his new shop with his younger brother Nelson and then brought in their older brother, Michael. (His third brother, Scott, had studied astrophysics but decided that "there was no future in astrophysics" and eventually turned himself into an ophthalmologist.) Seo named his firm Fermat Capital Management, after one of his intellectual heroes. "I had once read the letters between Pierre de Fermat and Blaise Pascal," he wrote in a recent e-mail message. "From my father I had learned that most great mathematicians were nasty guys and total jerks (check out Isaac Newton . . . extra nasty guy), but when I read

the Fermat-Pascal letters, you could see that Fermat was an exception to the stereotype . . . truly a noble person. I loved his character and found that his way of analyzing profitless games of chance (probability theory) was the key to understanding how to analyze profitable games of chance (investment theory)."

Four years later, Seo's hedge fund still faced two problems. The smaller one was that investors were occasionally slow to see the appeal of an investment whose first name was catastrophe. As one investor put it, "My boss won't let me buy bonds that I have to watch the Weather Channel to follow." That objection doesn't worry Seo much. "Investors who object to cat-bond investing usually say that it's just gambling," he says. "But the more mature guys say: 'That's what investing is. But it's gambling with the odds in your favor.' "

His bigger problem was that insurance companies still didn't fully understand their predicament: they had $500 billion in exposure to catastrophe but had sold only about $5 billion of cat bonds — a fifth of them to him. Still, he could see their unease in their prices: hurricane- and earthquake-insurance premiums bounced around madly from year to year. Right after Andrew, the entire industry quintupled its prices; a few tranquil years later, prices were back down nearly to where they had been before the storm. Financial markets bounced around wildly too, of course, but in the financial markets, the underlying risks (corporate earnings, people's moods) were volatile. The risk in natural-disaster insurance was real, physical and, in principle, quantifiable, and from year to year it did not change much, if at all. In effect, the insurers weren't insuring against disaster; they were only pretending to take the risk, without actually doing so, and billing their customers retroactively for whatever losses they incurred. At the same time, they were quietly sneaking away from catastrophe. Before the 1994 Northridge earthquake, more than a third of California homeowners had quake insurance; right after, the insurers fled the market, so that fewer than 15 percent of California homeowners have earthquakes in their policies today.

The market was broken: people on fault lines and beachfronts were stuck either paying far too much for their insurance or with no real coverage except the vague and corrupting hope that, in a crisis, the government would bail them out. A potentially huge, socially beneficial market was moments from birth. All it needed was a push from nature. And so on Aug. 24, 2005, John Seo was waiting, waiting for a storm. And here it came.

Wall Street is a machine for turning information nobody cares about into information people can get rich from. Back when banks lent people money to buy homes and then sat around waiting for interest payments, no one thought to explore how quickly homeowners would refinance their mortgages if interest rates fell. But then Wall Street created a market in mortgage bonds, and the trader with better information about how and when people refinance made a killing. There's now a giant subindustry to analyze the inner financial life of the American homeowner.

Catastrophe bonds do something even odder: they financialize storms. Once there's a market for cat bonds, there's money to be made, even as a storm strikes, in marginally better weathermen. For instance, before the 2005 hurricane season, a Bermuda cat-bond hedge fund called Nephila found a team of oceanographers in Rhode Island called Accurate Environmental Forecasting, whose forecasts of hurricane seasons had been surprisingly good. Nephila rented the company's services and traded bonds on the back of its reports. "They kind of chuckle at what we do," says a Nephila founder, Frank Majors. "The fact that we're making $10 million bets on whether Charley is going to hit Tampa or not. It made them a little nervous at first. We told them not to worry about what we're going to do with the information. Just give it to us."

As Katrina bore down on New Orleans, a cat bond named Kamp Re, issued by the insurance company Zurich, was suddenly at risk. If Zurich lost more than $1.2 billion on a single hurricane in about a two-year period, investors would lose all their money. If Zurich represented about 3 percent of the U.S. insurance market — that is, it was on the hook for about 3 percent of the losses — a hurricane would need to inflict about $40 billion in damage to trigger the default. Since no event as big as this had ever happened, it was hard to say just how likely it was to happen. According to R.M.S., there was a 1.08 percent chance that Kamp Re bond holders would lose all their money — assuming the scientists really understood the odds. The deal had been a success. One of its biggest buyers was John Seo.

As Katrina spun, the players in nature's casino gathered around the table. When the storm jogged east and struck not New Orleans directly but the less populated, and less wealthy, coastline between Louisiana and Mississippi, they all had the same reaction — relief — but Hemant Shah felt a special relief. Shah is one of the founders of R.M.S., and he was at that moment driving to catch a flight from San Francisco to New York, where he hoped to speak at a conference devoted to predicting terrorism. When he saw Katrina miss New Orleans, he said to himself, O.K., it's big, but it's not catastrophic, and he boarded his plane.

As he flew across the country, R.M.S. and its competitors replicated Katrina inside their computers in much the same way that Karen Clark had once replicated Hurricane Andrew. Just hours after landfall, all three firms sent clients in the insurance industry their best estimates of financial losses: R.M.S. put them at $10 billion to $25 billion; Eqecat called for a range between $9 billion and $16 billion; Clark's A.I.R. had a range of $12.7 billion to $26.5 billion. Big, as Shah said, but not catastrophic. Traders who had underwritten Kamp Re took calls from an investor at a Japanese bank in London. Cheered by Katrina's path, the fellow was looking to buy some Kamp Re bonds. The traders found another investor eager to unload his Kamp Re holdings. The London investor bought $10 million of Kamp Re at a price of $94.

John Seo just watched. For the past four years, he and his brothers had made money at such moments as this: "live" cat trading, it's called. A few investors would inevitably become jittery and sell their cat bonds at big discounts, what with the Weather Channel all hysteria all the time. ("The worst place to go if you're taking risks," says one cat-bond investor, "is the Weather Channel. They're just screaming all the time.") But entering the 2005 hurricane season, the Seo brothers had reconsidered their habit of buying in a storm. "The word had gotten out that buying in the storm was the smart thing to do," Seo says. "And we were afraid our past successes would give us an irrational interest in buying. Everything's all fuzzy in these events. And when things are fuzzy, your brain gives you an excuse to push the envelope. So we adopted a policy, before the season, of staying out of the market."

A few hours later, Hemant Shah's plane landed in New York. Shah turned on his BlackBerry and discovered that the New Orleans levees had broken: much of the city would soon be underwater. "My first reaction," Shah says, "was, Uh-oh, we have a problem." In the imaginary 100,000-year history of hurricanes that R.M.S. had in its computers, no hypothetical storm that struck so far from New Orleans had ever caused the levees to fail. The models, like the intuition they replaced, had a blind spot.

The Kamp Re bonds collapsed, the price dropping from the mid-90s to the low 20s. A few weeks later, an announcement from Zurich American made it clear that the investors in Kamp Re wouldn't be getting any money back, and Kamp Re's price fell from $20 to 10 cents. But then the real trouble started: R.M.S., the

modeling company, declared that it was rethinking the whole subject of hurricane risk. Since 1995, scientists had noted a distinct uptick in hurricane activity in the North Atlantic Basin. The uptick had been ignorable because the storms had not been making landfall. But between July 2004 and the end of 2005, seven of history's most expensive hurricanes had struck the American coast, leaving behind 5.5 million insurance claims and $81 billion in insured losses. The rise in hurricane size and frequency was no longer ignorable. R.M.S. convened a panel of scientists. The scientists agreed that unusually warm sea-surface temperatures were causing unusually ferocious and frequent storms. The root cause might be global warming or merely the routine ups and downs of temperatures in the North Atlantic Basin. On cause they failed to agree. On consequence they were united. At the beginning of August 2005, R.M.S. had judged a Katrina-size catastrophe to be a once-in-40-years event. Seven months later, the company pegged it as a once-in-20-years event. The risk had doubled.

It had been just 13 years since Karen Clark's model swept the industry, but the entire catastrophe risk-taking industry now lived at the mercy of these modelers. The scientists were, in effect, the new odds-makers. It was as if the casino owner had walked up to his roulette table, seen a pile of chips on 00 and announced that 00 would no longer pay 36:1 but would henceforth pay only 18:1. The agencies that rated the insurance companies — S & P, Moodys, etc. — relied on the scientists to evaluate their exposure. When the scientists increased the likelihood of catastrophic storms, S & P and Moodys demanded that the insurance companies raise more capital to cover their suddenly more probable losses. And so in addition to the more than $40 billion they had lost in Katrina, the insurance companies, by edict of the ratings agencies, needed to raise $82 billion from their shareholders just to keep their investment-grade rating. And suddenly they weren't so eager to expose themselves to losses from hurricanes.

John Seo felt differently. Katrina had cost him millions. But at the same time, in a funny way, it had vindicated his ideas about catastrophe. He had lost only what he had expected to lose. He had found an acceptable mode of failure.

As a boy, John Seo learned everything he could about the Titanic. "It was considered unsinkable because it had a hull of 16 chambers," he says. The chambers were stacked back to front. If the ship hit something head on, the object might puncture the front chamber, but it would likely have to puncture at least three more to sink the ship. "They probably said, What are the odds of four chambers going?" he says. "There might have been a one-in-a-hundred chance of puncturing a single chamber, but the odds of puncturing four chambers, they probably thought of as one in a million. That's because they thought of them as independent chambers. And the chambers might have been independent if the first officer hadn't gambled at the last minute and swerved. By swerving, the iceberg went down the side of the ship. If the officer had taken it head on, he might have killed a passenger or two, but the ship might not have sunk. The mistake was to turn. Often people associate action with lowering risk or controlling risk, but experience shows more often than not that by taking action you only make the risk worse."

The Titanic offered another lesson for the investor in catastrophe: the threats that seem to us the most remote are those we know the least about. Catastrophe risk is fundamentally different from normal risk. It deals with events so rare that experience doesn't help you much to predict them. How do you use history to judge the likelihood of a pandemic killing off 1 in every 200 Americans? You can't. It has happened only once. (The Spanish flu epidemic of 1918.) You lack information. You don't know what you don't know. The further

out into the tail you go — the less probable the event — the greater the uncertainty. The greater the uncertainty, the more an investor should be paid to live with it.

The financial markets, or, at any rate, the arcane corner of Wall Street that dealt exclusively with highly unlikely financial events, had figured this out. The traders who sold insurance against extreme market collapses — the tail risks — all tended to charge exactly the same price, between four and five times their expected losses. Expected loss could be defined like this: Say an investor wanted to buy $1 billion of insurance for a year against a once-in-100-years stock-market crash. The expected loss would be 1 in 100, 1 percent of $1 billion: $10 million. The insurance would thus cost $40 million to $50 million. The pattern held across Wall Street. The trader at Lehman Brothers who priced stock-market-crash insurance didn't know the trader at Harvard Management who priced the insurance against drastic interest-rate changes, and he didn't know the trader at O'Connor and Associates who priced the insurance against the dollar's losing a third of its value. But their idea of a fair premium for insurance against financial disaster suggested they were reading the same books on the subject — only there were no books. "The reigning theory is that the taste for risk is as arbitrary as the value of a painting," Seo says. "But if this is so, why are these preferences so consistent across markets?"

Seo thought, Maybe risk is not like art. Maybe there is some deep rule that governs it. And maybe the market is groping its way to that rule all by itself.

Intuitively what the market was doing made sense. Highly improbable events were especially unsettling. The person who insured others against an unlikely event faced not only the problem of judging its likelihood; even if he knew how often it would occur, he didn't know when it would occur. Even if you had complete certainty that a U.S. stock-market crash happened just once every 25 years, you still didn't know which year. If you had set up a business to sell crash insurance in January 1987, you would have been bankrupted by the crash in October; on the other hand, if you had gone into the business in 1988, you would have gotten rich. There was no justice in it. The catastrophic risk-taker was a bit like a card counter at the blackjack table allowed to play only a few hands: yes, the odds are in his favor, but he doesn't always get to play long enough for the odds to determine the outcome.

The uncertainty in these extreme, remote market risks meant that the person who took them should be paid more to do so. But how much more? Extreme events were treated on Wall Street as freak outliers that bore no relation to other, more normal events. There was a striking consistency in the pricing of these risks across Wall Street, but there was no hard logic under them: it was all being done by feel.

The logic is what Seo stumbled upon back in 2000 at Lehman Brothers after someone handed him a weird option to price. An industrial company had called Lehman with a problem. It operated factories in Japan and California, both near fault lines. It could handle one of the two being shut down by an earthquake, but not both at the same time. Could Lehman Brothers quote a price for an option that would pay the company $10 million if both Japan and California suffered earthquakes in the same year? Lehman turned to its employee with a reputation for being able to price anything. And Seo thought it over. The earthquakes that the industrial company was worried about were not all that improbable: roughly once-a-decade events. A sloppy solution would be simply to call an insurance company and buy $10 million in coverage for the Japanese quake and then another $10 million in coverage for the California quake; the going rate was $2 million for

each policy. "If I had been lazy, I could have just quoted $4 million for the premium," he says. "It would have been obnoxious to do so, but traders have been known to do it." If either quake happened, but not both, he would have a windfall gain of $10 million. (One of his policies would pay him $10 million, but he would not be required to pay anything to the quake-fearing corporation, since it would get paid only if both earthquakes occurred.)

But there was a better solution. He needed to buy the California quake insurance for $2 million, its market price, but only if the Japanese quake happened in the same year. All Seo had to do, then, was buy enough Japanese quake insurance so that if the Japanese quake occurred, he could afford to pay the insurance company for his $10 million California insurance policy: $2 million. In other words, he didn't need $10 million of Japanese quake insurance; he needed only $2 million. The cost of that was a mere $400,000. For that sum, he could insure the manufacturing company against its strange risk at little risk to himself. Anything he charged above $400,000 was pure profit for Lehman Brothers.

And that was that, except it wasn't. He saw something. Each risk by itself was not unusual: the quakes being insured against were once-a-decade events. But since each earthquake had a 1-in-10 chance of happening in a year, the chances that both of them would occur were far more remote: 1 in 100 (10 percent of 10 percent). When you combined these more ordinary risks, you simulated extremely unlikely ones. "What I noticed, after the fact, is that this exotic option's price was special," he says. "It was related to tail pricing." The risk of catastrophe wasn't some freak outlier with no connection to more mainstream risks. It bore a fixed relationship to those risks. Indeed, one way of thinking about natural catastrophes was as a combination of more likely events.

Thus the hunches of Wall Street professionals found vindication in Seo's arithmetic. The expected loss of the more ordinary risk of a single earthquake was $1 million (a 10 percent chance of a $10 million loss). The insurance cost $2 million, or twice the expected loss. The expected loss of the remote combined risk was $100,000 (a 1 percent chance of a $10 million loss). But the insurance cost $400,000: four times the expected loss. All those practical traders who were pricing tail risk at roughly four times the expected losses had been on to something. "Here I saw the beginnings of a market mechanism that directly links 1-in-10-year risk pricing to 1-in-100-year risk pricing," Seo says. The intuitive reason that extreme, remote risk should be more highly priced than normal everyday risk was "a happy agreement between human psychological perception and hard mathematical logic."

Seo's math — which soon left middle school for graduate school — served two purposes: to describe this universal rule about the pricing of risk and to persuade investors that there was a deeper, hidden logic to investing in catastrophe. They could have some sense of what the price of the risk should be. It was an extraordinary idea: that catastrophe might be fair.

Then came Katrina. The reaction to the storm has put a fine point on Americans' risk disorientation. The single biggest issue in Florida's 2006 governor's race, for instance, was the price of insurance. The Republican, Charlie Crist, got himself elected on the strength of his promise to reduce Floridians' home-insurance rates by creating a state-subsidized pool of $28 billion in catastrophe insurance coverage. "Florida took this notion of spreading this risk and turned it on its head," says one former state insurance commissioner. "They said, 'We're going to take all this risk ourselves.' " The state sold its citizens catastrophe

insurance at roughly one-sixth the market rates, thus encouraging them to live in riskier places than they would if they had to pay what the market charged (and in the bargain, the state subsidized the well-to-do who live near the beach at the expense of the less-well-to-do who don't). But if all the models are correct, $28 billion might not cover even one serious storm. The disaster waiting to happen in Florida grows bigger by the day, but for a man running for governor of Florida, ignoring it is a political no-brainer. If he's lucky — if no big storms hit in his term — he looks like the genius who saved Floridians billions in catastrophic-risk premiums. If he's unlucky, he bankrupts Florida and all hell breaks loose, but he can shake down the federal government to cover some of the losses.

Louisiana's politicians are usually quicker than most to seize upon shrewd politics that generate terrible social policy, but in this case they could not afford to. Louisiana cannot generate and preserve wealth without insurance, and it cannot obtain insurance except at the market price. But that price remains a mystery. Billions of dollars in insurance settlements — received by local businesses and homeowners as payouts on their pre-Katrina policies — bloat New Orleans banks and brokerage houses. The money isn't moving because the people are paralyzed. It's as if they have been forced to shoot craps without knowing the odds. Businesses are finding it harder than ever to buy insurance, and homeowners are getting letters from Allstate, State Farm and the others telling them that their long relationship must now come to an end. "I've been in the business 45 years," says a New Orleans insurance broker named Happy Crusel, "and I've never seen anything remotely like this." An entire city is now being reshaped by an invisible force: the price of catastrophic risk. But it's the wrong price.

Insurance companies, John Seo says, are charging customers too much — or avoiding their customers altogether — instead of sharing their risk with others, like himself, who would be glad to take it. New Orleans, as a result, is slower than it otherwise would be to rebuild. "The insurance companies are basically running away from society," he says. "What they need to do is take the risk and kick it up to us." They need to spread it as widely as possible across the investment world and, in the process, minimize the cost of insuring potential losses from catastrophes.

But this, too, is happening. The people on Wall Street who specialize in cat bonds now view Katrina as the single most important thing that ever happened to their business: overnight it went from a tiny backwater to a $14 billion market, and it is now stretching and straining to grow. In March of this year, a single insurer, Allstate, announced its intention to sell $4 billion in catastrophe bonds. A $14 billion market is a trivial sum next to the half-trillion or so dollars that the insurance industry stands to lose from megacatastrophes and next to the additional trillions of dollars worth of property that has gone uninsured in the places most likely to be destroyed by nature, like California, because the insurance is so expensive. But there are all around John Seo signs of a shift in the culture of catastrophe. "It has all the features of providential action," he says. "It's like all the actions of man and nature serve to grow the cat-bond market."

When Katrina struck and his Kamp Re bonds collapsed — from $100 to 0 — Seo was able to view his loss with detachment. The models had badly underestimated the risk, but it was in the nature of extreme risk that the prediction of it would sometimes be mistaken. "The important thing is that the money wasn't lost in an unearned manner," he says, by which he means that it wasn't lost dishonestly or even unwisely or in what his community of investors would consider a professionally unacceptable manner. Investors will endure losses as long as they come in the context of a game they perceive as basically fair, which is why they don't abandon

the stock market after a crash. "That's all I need to know," Seo says. "That's all my clients need to know." Actually, he goes even further: "I would be embarrassed if we had a big event and our loss wasn't commensurate with it. It would mean that we didn't serve society. We failed society."

Seo's returns in 2005 were only slightly positive, compared with the roughly 10 to 12 percent he had been delivering, but the demand for his services boomed. He now controls $2 billion, or more than twice what he had before the most costly natural disaster in history. Big investors weren't scared off by Katrina. Just the reverse. It has led many of them to turn to Seo and others like him to make money from catastrophe. And they probably will. But what interests Seo more is what might happen in the bargain, that the financial consequences of catastrophe will be turned into something they have never been: boringly normal.

Michael Lewis is a contributing writer. The paperback edition of his book "The Blind Side: Evolution of a Game" will be published next month.

~~Health~~ INS

Dear Tim Mahoney,

I come from the town of Stuart. My home is a wood frame home built in the 70's. I am a single mom of two boys. I do receive child support for both of my boys. I work at the Veteran's Hospital in West Palm Beach.

I once thought of myself as one of the lower middle class. I now believe to be one of the working poor.

In September of 2006 my Insurance company dropped me. I then had to find a new Insurance Company my choices came from three different companies. The cheapest was Hull and Company @ $4,100.00 the other two choices were from Citizens Insurance company one for $5,000.00 and $6,000.00. Needless to say I went with the cheaper of the three. The cheapest being Hull and company at $4,100.00 and this was still more than triple what I had paid the previous year of $1,200.00.

Since September of last year I am doing what I can to downsize my bills. I have also been working overtime every Saturday.

I am trying to get rid of one of my dogs which is very difficult we are attached to him. I have gotten rid of our family gym membership to YMCA. I am also going to have to get rid of Direct Tv. I did have to get rid of our internet Service. As you can see these Insurance Increases are not only affecting the people who live in these homes but the companies that provide these services. We use to spend around $100.00-$150.00 a week on groceries. I have had to cut that down to $60.00 a week. This is to feed me, my seventeen year old son, and my five year old son.

I am behind on bills now just to pay my homeowners insurance.

I am glad to hear that you and the other politicians are finally trying to do something to reduce the cost of insurance. You have to keep in mind that when you give discounts for hurricane windows, shutters, hurricane proof garage doors, and any of the other luxury hurricane items, most of the people struggling don't have the money for these upgrades and therefore can not get the discounts on their insurance.

I never had a claim in for any of the hurricanes. Although I was near the eye for Jeanne and Francis. I was fortunate to have very minor damage. But I am paying for everyone else that put in a claim and received money for their damage. I think if people put in a claim and receive money their insurance should increase . Just like if you get a speeding ticket your get points on your car Insurance and your premium goes up.

I hope that the insurance companies that made all of that money for all of those years that there were no hurricanes and then ditched all those homeowners after the hurricanes came have to pay either by taking huge pay cuts or giving up their bonuses.

I also heard tonight on the news that homeowners that have Citizens Insurance may be getting discounts. I think that discounts should go for all homeowners no matter what Insurance company they' have.

RECEIVED

[illegible]

Sincerely,
Ms. Leanne Finnigan
Ms. Leanne Finnigan